VOLUME TWO

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THE FEDERAL RESERVE SYSTEM

ITS ORIGIN AND GROWTH

Reflections and Recollections

BY

PAUL M. WARBURG

VOLUME TWO

ADDRESSES AND ESSAYS

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FOREWORD

Part One of this volume is a reprint of the one issued in July, 1914 in the *Proceedings of the Academy of Political Science in the City of New York, Columbia University, Volume IV, Number* 4, under the title *Essays on Banking Reform in the United States*, by the author. For permission to reprint the articles in the form in which they first appeared as a collection, fifteen years ago, the author is indebted to the Academy of Political Science. At the request of the Academy, the text of the various articles, the editor's notes, and the Introduction by Professor Edwin R. A. Seligman, have been reprinted in their original form. The only change made consists of the addition of the paper "A Modified Central Bank of Issue, A Suggestion of a Bill" (April, 1908) which, by an oversight, had been omitted in 1914.

The essays reprinted in Part One cover the period before the enactment of the Federal Reserve law.

Part Two contains a selection of articles published since then. Series "A" of Part Two embodies those written during the author's service on the Federal Reserve Board (August 10th, 1914 to August 10th, 1918). Series "B" includes articles published after his membership had ceased; they deal with problems touching the Federal Reserve System and with the broad questions of domestic and international finance, as they were challenging bankers' minds in the years of 1918 to 1924.

Articles unrelated to the banking problem have been excluded from the selection.

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PART ONE

INTRODUCTION

THE essays which are here collected and published in book form not only are valuable in themselves but form a landmark in the history of American contributions to the banking problem. It is in a general way known to the public that Mr. Warburg was in some way connected with the passage of the Federal Reserve Act, and his appointment to his present responsible position on the Federal Reserve Board was acclaimed on all sides with a rare degree of approval and congratulation; but I fancy that it is known only to a very few exactly how great is the indebtedness of the United States to Mr. Warburg. For it may be stated without fear of contradiction that in its fundamental features the Federal Reserve Act is the work of Mr. Warburg more than of any other man in the country.

Up to a very few years ago, virtually all the efforts of the banking reformers in this country were directed to securing what was called elasticity of the currency, through the abolition of the bond reserve for bank-note circulation. Neither the report of the Indianapolis Monetary Conference nor the schemes of the committee of the New York Chamber of Commerce a decade later attempted to do anything more than that; and no single plan seemed to approve itself to the country. The two new ideas which were injected into the discussion by Mr. Warburg were, first, the shifting of the emphasis from the currency problem to the reserve problem, and second, the advocacy of the principle of rediscounting a new kind of commercial paper.

The first point is fully explained in the essay on the United Reserve Bank of the United States. Mr. Warburg recalled to our mind what had been forgotten by most of us, that the real pith of modern banking is the question of the reserve, and that the essential weakness of the American system was the extreme decentralization of resources, resulting in the time of stress or trouble in every individual bank attempting to secure its own solvency in disregard either of the welfare of other banks or of the needs of the business community. In essay after essay Mr. Warburg hammered on this one idea until he got it firmly fixed in the opinion, first of the experts and then of the general public. Without some method of combining the scattered resources of the individual banks it was clear that no essential progress could be made.

The second point was equally new to the American public, although, like the first, it was a familiar achievement of modern banking reform abroad. Mr. Warburg pointed out that the absence of proper two-name commercial paper and the non-existence of any central bank or banks at which such paper could be instantly rediscounted for cash, compelled the banks either to invest their money in illiquid securities or to loan the funds on the stock exchange, thus producing the remarkable variations in the money rate and bringing about the periodical stringency in the money market. After his lucid exposition of what might be accomplished by a rediscounting and thus introducing into the United States the so-called discount policy of European countries, it was gradually realized that this was the second essential feature of banking reform.

Mr. Warburg also called attention to the advantages of a new currency not based upon the deposit of government bonds, but he made it clear that this reform, which was the sole objective of all previous schemes, was of only minor importance and that it would follow as a necessary consequence from the adoption of the two fundamental points mentioned above. These two principles form the real backbone of the new Federal Reserve Law. When the Aldrich commission was appointed it was not long before Senator Aldrich—to his credit be it said—was won over by Mr. Warburg to the adoption of these two fundamental features. The Aldrich Bill differed in some important particulars from the present law.

It went further in the direction of centralization and it involved less control by the government of banking operations. The new act is in some details superior to the Aldrich Bill; in others inferior. The concession in the shape of the twelve regional reserve banks that had to be made for political reasons is, in the opinion of Mr. Warburg as well as of the writer of this introduction, a mistake; for it will probably, to some extent at least, weaken the good results which would otherwise have followed. On the other hand, the existence of the Federal Reserve Board creates, in everything but in name, a real central bank; and it depends largely upon the wisdom with which the Board exercises its great powers as to whether we shall be able to secure most of the advantages of a central bank without any of its dangers.

In many minor respects also the Federal Reserve Act differs from the Aldrich Bill; but in the two fundamentals of combined reserves and of a discount policy, the Federal Reserve Act has frankly accepted the principles of the Aldrich Bill; and these principles, as has been stated, were the creation of Mr. Warburg and of Mr. Warburg alone.

It is this fact which gives especial interest to the present collection of essays which are printed just as they were originally published and which show the gradual development, in unimportant points, of Mr. Warburg's thought. In weighing the merits of these essays it must not be forgotten that Mr. Warburg had a practical object in view. In formulating his plans and in advancing slightly varying suggestions from time to time, it was incumbent on him continually to remember that the education of the country must be gradual, and that a large part of the task was to break down prejudices and remove suspicions. His plans therefore contain all sorts of elaborate suggestions designed to guard the public against fancied dangers and to persuade the country that the general scheme was at all practicable. It was the hope of Mr. Warburg that with the lapse of time it may be possible to eliminate from the law not a few clauses which were inserted, largely at his suggestion, for educational purposes.

As it was my privilege to say to President Wilson when originally urging the appointment of Mr. Warburg on the Federal Reserve Board, at a time when the political prejudice against New York bankers ran very high, England also, three-quarters of a century ago, had a practical banker who was virtually responsible for the ideas contained in Peel's bank act of 1840. Mr. Samuel Jones Loyd was honored as a consequence by the British government and was made Lord Overstone. The United States was equally fortunate in having with it a Lord Overstone. And while it is not the custom for America to confer peerages upon its distinguished citizens, it is fortunately beginning to become the practice to induce them to accept positions of great public responsibility in which they can at once serve the community and honor themselves.

It is my especial pleasure to be able to write these few words of introduction, because it was in my study that Mr. Warburg first conceived the idea of presenting his views to the public. When he began to chat familiarly on the subject he at once impressed his listeners by the importance and novelty of his views. His modesty and his shrinking from public controversy were so pronounced that it was only with the greatest difficulty that he was persuaded to put his ideas on paper. But having once set out on the task, there was no stopping, and from year to year essay upon essay flowed from his facile pen, giving more precision and point to his fundamental principles, until he was recognized as the real leader in the new movement. The Federal Reserve Act will be associated in history with the name of Paul M. Warburg, and the Academy of Political Science deem it a rare privilege to be able to present to the public this volume of his collected essays.

EDWIN R. A. SELIGMAN

LAKE PLACID, NEW YORK
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I

DEFECTS AND NEEDS OF OUR BANKING SYSTEM

THE question of the reform of the currency system is uppermost in the minds of all, not only in our own country, but in Europe as well; for Europe also is vitally interested in the problem. So much has been said and written on this subject that it is almost a presumption to seek to add any new thoughts. There is, however, one point which has not as yet been sufficiently emphasized, but which appears to lie at the very root of the problem. This is the question of our commercial paper.

It is a strange fact that, while in the development of all other commercial phenomena the United States has been foremost, the country should have progressed to so slight an extent in the form of its commercial paper. The United States is in fact at about the same point that had been reached by Europe at the time of the Medicis, and by Asia, in all likelihood, at the time of Hammurabi. Most of the paper taken by the American banks still consists of simple promissory notes, which rest only on the credit of the merchant who makes the notes, and which are kept until maturity by the bank or corporation that discounts them. If rediscounted at all, they are generally passed on without endorsement, and the possibility of selling any note depends on the chance of finding another bank which may be willing to give the credit. The consequence is that, while in Europe the liquid assets of the banks consist chiefly of bills receivable, long and short, which thus constitute their quickest assets, the American bank capital invested in commercial notes is virtually immobilized.

In Europe—as for instance in England, France, or Germany —there are scores of banks and private banking firms which give their three-months' acceptance for the commercial requirements of trade, or which make it their specific business to endorse commercial bills. A commercial borrower in these countries who does not get a cash advance will do one of two things. He will either sell to his bank or his broker his own three-months' bill drawn on a banking firm willing to give him this credit, or he will sell the bills drawn by him on his customer (in payment for goods sold to them), which bills will be subsequently passed on with the endorsement of the banker. This banker's acceptance, or this endorsed paper, can be readily negotiated by the buyer at any time whenever there is a profit to be derived, or whenever the holder desires to realize on the bill. The holder will always be able to dispose of it, either through private discounting or, in case of need, by selling, as the case may be, to the Bank of England, the Banque de France, or the German Reichsbank. In any event, the firm or corporation which buys this paper can secure its equivalent at any time. The quality of the bills, assured by the established credit of the acceptor or by the various endorsements on the bill, is such as practically to eliminate the question of credit, and the conditions of the sale will depend only on the rate of interest.

The value of the existence of thousands of millions of such standard paper, as it is found in all the important European financial centres, can scarcely be sufficiently emphasized. Just as the check system is a method of clearing bank cash credits, thus helping largely to prevent unnecessary absorption of the currency, so modern commercial paper, through the additional safety which is secured by the banker's endorsement, acts in like manner as a clearing of credits on time not only within the community, but, what is just as important, among the various nations as well.

If money tightens in Europe, let us say in Germany, France and England will immediately invest in German bills. They could not buy the paper of individual German merchants, whom they do not know, but they do and must know the value of the acceptance or endorsements of the German banks which offer and endorse or accept this paper. By a well organized system of such bills of exchange the credit of the whole nation —that is, of the farmer, merchant, and manufacturer—is joined to that of the banker and becomes available as a means of exchange both within and without the country.

Under present conditions in the United States, on the other hand, instead of sending an army, we send each soldier to fight alone. With us the borrower receives money from the bank and his note becomes an illiquid asset in the bank's portfolio. If the bank desires to raise money, it must use its own credit, instead of adding its own credit to that of the borrower, thus making the dead note a live instrument of exchange. The only modern bills in our country are the so-called "foreign exchange" bills, drawn on European banks and bankers, which are endorsed and which always have a ready market.

But what an anomalous position! Instead of having the credit of the entire country available in the shape of millions upon millions of modern paper which Europe might and would buy, we must rely on the willingness and the ability of a few banks and bankers to use their own credit by drawing their own long bills on Europe. This is a costly and most unscientific mode of procedure, which is in no way adequate to the necessities of the situation. For there is, as a matter of course, a limit to the amount which the American banker can draw and which the European banker will and can accept.

Recent events have shown the inefficiency of this system. In spite of unwise provocation the government banks of Europe would not and could not have made a stand against us (as they have done during these past few months by raising their rates of discount and by discriminating against our so-called finance paper) had we been able to send our legitimate commercial paper instead of forcing the banks and bankers to draw their own bills. These bills, it is true, indirectly help commerce, for a bank which requires money in order to accommodate its merchant customers will call its stock-exchange loans, while bills drawn against stock-exchange collateral will in turn provide the money that has thus been called.

But such bills must inevitably bear a financial character, and will not be regarded so favorably as commercial paper would be. Moreover, since the drawers and, to an even greater extent, the European acceptors, are comparatively few, the European banks must at times feel that they are getting too large an amount of paper drawn on and endorsed by the same firms. As these bills, drawn, as the case may be, in pounds, francs, or marks, sell normally at the same rate of private discount as all the other long bills in the country, the European banks find no particular inducement to purchase them. When, therefore, there is an excessive amount of these American bills offered, the consequence is discrimination, and, what is worse—owing to the financial aspect of the bills—a feeling of uneasiness and distrust.

If instead of this unfortunate method of financing we could offer American paper drawn in dollars, showing its commercial origin and endorsed by and drawn on American banks or banking firms, we should vastly multiply the avenues leading into the portfolios of the European banks, and our bills would be well spread instead of going into a few channels which can so easily be closed. We should create a new and most powerful medium of international exchange—a new defense against gold shipments. This is no visionary theory. In view of the fact that a great many millions of even Russian bills are constantly held by French, English, and German banks, institutions, and capitalists, there is no reason whatsoever to doubt that these same avenues could be readily opened to American paper.

In order thus to make our paper part and parcel of the means of the world's international exchange, it needs, however, as a preliminary condition, to become the foundation on which our own financial edifice is erected. It must always have a ready home market, where it can be rediscounted at any moment. This is insured in nearly every country of the world claiming a modern financial organization, by the existence of some kind of a central bank, ready at all times to rediscount the legitimate paper of the general banks. Not only England, France, and Germany have adopted such a system, but all the minor European states as well—and even reactionary Russia—have gradually accepted it. In fact, Japan without such an organization could not have weathered the storm through which she has recently passed, and could not have achieved the commercial success which she now enjoys.

Our methods are just the reverse of the European system. With us call money does not go into the bill market. Every American bank, since it cannot count on reselling the notes which it buys, must necessarily limit the amount which it can properly invest in American paper, and as a consequence almost all the call money is invested in demand loans on the stock exchange. The result of this is that the overflow of money of the entire country, from the Atlantic to the Pacific, is thrown into the stock exchange, making stock-exchange money easy and stimulating speculation when trade is relaxing, while on the other hand, as soon as demand for money for commerce and industry increases, the funds to provide for the needs of the whole country are called from the stock exchange, causing a disturbance there.

Our whole elasticity is built up on the bond and stock market. Banks can issue notes on government bonds, and call money is kept in stock-exchange loans. In Europe the situation is reversed; banks issue notes primarily against their purchases of bills of exchange, and the reserves of the country are kept primarily in bills of exchange.

In Europe, banks and bankers invest against their deposits chiefly in bills of exchange, short and long, and only to a comparatively small extent in fortnightly or monthly settlement money on the stock exchange or in call loans on stock-exchange collateral. If call money becomes easier, it is in the first instance the rate for short and long bills that goes down, and since this rate is practically the same all over the country, a withdrawal or an influx of money, instead of being felt primarily by the stock exchange, is borne equally by thousands of millions, the grand total of all money invested in such bills being a great many times larger than the comparatively small amount employed in stock-exchange loans. It is like throwing a pebble into a pond; the ripples will slowly spread in concentric circles, until in the end they are scarcely perceptible. With us it is like casting a stone into a small basin; the entire surface is suddenly and violently agitated for a short time.

To explain briefly the workings of a European central bank, to show how little political power need attach to it and how little it interferes and need interfere with the business of the general banks (except to act as a general brake on the market, if it over-extends, and to provide for the needs of the country, as long as they are legitimate) it may be well to say a few words about the German Reichsbank, admittedly the most perfect organization of its kind.

The capital stock of the German Reichsbank is owned partly by the government and partly by the public. The Reichsbank has a central board in Berlin, consisting of the foremost men in financial and commercial circles. The president of the bank is a salaried officer, a trained banker (no politician) who retains his position irrespective of the party in power, like the president of any private bank who remains in office as long as he does his work well. The Reichsbank has its branches in every important town similar to our central reserve and reserve cities. Each branch has its own board of directors, consisting of ten or twenty men, representing the best financial and commercial men in the locality, while each branch has its own salaried president, responsible to the board.

The chief duty of the bank, leaving all other details not bearing upon our subject aside, is to buy at the published bank rate legitimate paper, which must bear the acceptance or endorsement of at least two well-known banks or bankers. This bars the Reichsbank from doing a general commercial business, and converts it practically into a bank for the other banks.

Moreover, the published rate of the Reichsbank is, as a rule, from ½ of 1 per cent to 1 per cent higher than the private discount rate at which the other banks buy paper. Since, however, the central bank has branches in every town, the banks use it chiefly in the normal course of events for the collection of bills throughout the entire country as they fall due. The bank has its established rules for such collections, deducting at its published rate from five to ten days' interest, according to the distance of the towns on which the bills are drawn, but not charging any commission.

According to this system, for instance, a Hamburg bank, owning a bill on Munich, would sell the bill to the Reichsbank five days before it falls due, simply rediscounting the last five days at the bank rate. A Munich bank having a bill on a Hamburg bank would do the same, both getting the money immediately, while the Reichsbank, as the general clearing house, would simply transfer on its books the credits of the one branch to those of the other. Through a system of this kind it is possible to avoid the constant remittance of cash and the locking up of money by the banks. The advantages that a system of this kind would bring to the United States are obvious.

When money tightens in Germany the banks rediscount through the Reichsbank their short bills which have a little more than five days to run, and as the private discount rate throughout the country rises, the bills that the banks rediscount will gradually be longer and longer. While this process is in progress, the private discount rate and the bank rate will be approaching each other. If rates are comparatively low, the general tendency of the Reichsbank will be to advance its rate, so as not to be forced to put out too large an amount of notes issued in payment for the bills. For, as is well known, the bank is compelled to pay a tax when its note circulation exceeds a certain limit. After a normal amount of its notes is out, the Reichsbank will, therefore, tend to keep its rate well above that of the ordinary banks until the rate of interest received in discounting paper is high enough to indemnify the Reichsbank for the payment of the tax.

As a consequence the Reichsbank, as a rule, keeps its rate high enough to leave to the ordinary banks the general business and the fixing of the rates at which this business is conducted. By raising or lowering its rate, however, the Reichsbank indicates the general trend and exerts a moral and practical influence on the tendency of the banks to extend or to restrict business. If money is low in Germany and high in other countries, with a natural consequence that German capital would leave the country, and gold as a result be exported, the Reichsbank will work for a higher rate of interest as a precautionary measure, and the general banks will, as a rule, follow the Reichsbank's lead.

In the opposite case, however, when money is becoming very scarce in Germany, there is no fear at any time of a money squeeze, as the Reichsbank, on paying the tax, can issue a virtually unlimited amount of notes as long as safe and legitimate paper is offered for discount. In times of very high money the Reichsbank will at a certain point cease to keep its own rate above the private discount rate of the banks, and at such times the ordinary banks will often rediscount with the Reichsbank not only the short bills, but even the long ones. Thus the duties of the Reichsbank are, on the one hand, to counteract the influence of too abundant a money supply, and on the other hand, to furnish at legitimate rates all the money that the country legitimately may require.

It should be added here that the Reichsbank also makes loans on collateral. There is, however, a fixed rate for this, namely, 1 per cent above the bank rate. This is, as a rule, a much higher rate than that at which the general banks will furnish the money, and in addition there exist very strict regulations as to the kind of securities on which the Reichsbank is permitted to advance money and as to the percentage of the market value of the securities which it may loan. Since these rules are much more rigid than those of the general banks, nobody would under normal circumstances apply to the Reichsbank for a loan on collateral. When money becomes scarce, however, the banks or the bankers can always count on the Reichsbank to fall back upon, and in case of a crisis this is readily done.

The ability of the Reichsbank to advance against securities is, however, of minor importance as compared with the fact that the existence of such an institution forms the foundation on which is erected the whole system of financing the business interests of the empire on bills; for this results in an elastic system, expanding and contracting, according to the requirements of trade and industry.

Reason, as well as the experience of all other nations, tells us that we in the United States should attempt to reorganize our present system of issuing and handling commercial bills, in order to create the basis necessary for a modern system of currency and finance. Not only, however, should we endeavor to make such bills the medium of equalizing the daily demand for and supply of money, but we should also by all means try to break with the other system, which makes call loans on stock-exchange collateral serve for this purpose.

Let us next consider another point of some importance. The principal stock exchanges in Europe have their dealings for fortnightly or monthly settlements, while on the New York Stock Exchange all transactions are for daily cash settlements. The advantages of the European system are obvious; it avoids unnecessary duplication of work and unnecessary outlay of money, and it assures a greater stability.

In Europe, the "positions" are "carried" from one settlement to the next; that is to say, the broker borrows or lends the money from the end or the middle of the month to the next settlement day at a rate of interest agreed upon in advance. Unlike his unfortunate New York brother, he need not find his money from day to day, and he need not fear that money rates will jump from 4 per cent to 100 per cent, or that, even at such rates, he may not be able to secure the money at all.

In Europe, the amount employed on the stock exchange is a fairly constant one. The daily plus and minus of the demand for or the supply of money is adjusted in the bill market, and if more money is required on settlement days and the rate of settlement money rises, the normal consequence is that more money will go from the bill market to the stock exchange, and be employed there until the next settlement. This process takes place year in and year out practically without any serious disturbances; fluctuations and exorbitant money rates such as we have so frequently witnessed in this country are not only unheard of, but absolutely inconceivable in Europe. From settlement to settlement in Europe the broker and the customer are safe; the stock-exchange loans remain unchanged.

If such a system of settlements were to be established on the New York Stock Exchange—for which case it would be advisable, in order not to stimulate gambling, to provide in some way for putting up margins to protect the contracts—several objects would be achieved. In the first place, individuals would be in a position to secure money for a reasonable time and at reasonable rates, and panicky fluctuations, so frequent at present, would become rare. Secondly, the regulation of the daily supply and demand of money would be forced from the stock exchange into the bill market.

It should be added here that our present system of cash dealings on the stock exchange is forced upon us as the result of the unreasonable usury law of the State of New York, which, although making it unlawful to take more than 6 per cent on time loans, is in reality the direct cause of an almost confiscatory rate being charged from day to day for weeks at a time.

That the usury law should provide a maximum rate for pawn shops or for small individual loans is defensible, but for large business transactions most of the European laws do not limit the rate. Even in those countries which still retain some form of usury laws, in order to constitute usury it must be proved that the party taking the money was in dire stress and that the party loaning the money designedly took advantage of the debtor's helpless position to exact an exorbitant rate. If the height of the rate is to be the deciding factor in judging whether usury has been exacted, the law ought to state the maximum amount permissible in excess of the ruling interest rate of the country (like, e.g., the bank rate abroad).

But for the large transactions of a country one fixed maximum rate cannot be laid down by law. It is preposterous to extend such a principle to the business of large solvent houses, and to prevent them from making a legally binding contract for time money at more than 6 per cent in the face of the fact that such a loan at 7 per cent or even 8 per cent might be of the greatest benefit to them, while the impossibility of securing money except on call at ridiculous rates might cause the most severe loss of money and of business. Conditions like the present show the absurdity of such a system; when money in Europe is worth more than 6 per cent on time—as happens to be the case just at present—the consequences can only be that under present circumstances some people will loan at more than 6 per cent on time, and take the risk of such illegal action. As there are, however, comparatively few, the call rate must rise to such an abnormal height as is necessary to keep money from going abroad or to attract a new supply to our country. But as this exorbitant rate for call loans may break from day to day, in consideration of the resulting risk of exchange connected with the transaction, one might say that the rate for short money, in order to attract foreign capital, will rise about 10 per cent to 20 per cent, where the rate for time money would have to rise only 1 per cent.

With no modern paper to offer, with the usury law limiting the legal time rate to 6 per cent, and with an unwritten law, observed by many banks, not to charge their regular customers more than 6 per cent, even on call loans, our only primitive means of protecting the country are either an immense rate for call loans in the open market or a violent break in the price of our securities, as a rule the consequence of such shortage of money. This break must bring our securities down to a level where Europe will buy, and ultimately results in a relief of our money market by reason of remittances from abroad for such purchases.

Such are the consequences of the perpetuation of an absurd system which has been abandoned everywhere else. Banks and bankers may by manipulation sometimes exaggerate the disgraceful conditions which exist in our money market, but the direct cause is our present system, which makes these occurrences, as it has been endeavored to make clear, absolutely inevitable.

Our immense national resources have enabled us to live and prosper in spite of our present system, but so long as it is not thoroughly reformed it will prevent us from ever becoming the financial centre of the world. As it is, our wealth makes us an important but dangerous factor in the world's financial community, with immense resources indeed, but without a central organization of our own, using and sometimes abusing the financial organization of Europe in order to atone for our own shortcomings; unable effectively to put on the brakes ourselves, we compel the government banks of Europe to take measures for the regulation of our own household.

In closing, a few words may be said about the propositions now before the country with reference to currency reform. At the outset we were between Scylla and Charybdis; on the one hand the tendency to give unlimited power to the Secretary of the Treasury—a political officer, possibly untrained in the banking business and one who, although probably in most cases unselfish and wise, may also be selfish and unwise; and on the other hand the movement of the bankers' association to take all power from the Treasury, forcing it to put out its money at a fixed rate and practically vesting its power in the national banks. The one tendency appears to be as bad as the other; it is dangerous to give so much power to one individual who is not in business, but it is equally dangerous to give so much power to men who are all in business. The bills recently introduced in Congress show a material improvement on these first attempts.

The one bill, known as the Elkins Bill, which empowers the Secretary of the Treasury to deposit with the national banks against collateral all moneys received—including custom-house revenues—leaving the rate of interest, however, to be fixed in his discretion, deserves unqualified endorsement. It leaves a vast discretionary power with the Secretary, but this is a necessary evil as long as we have no central bank. To make the Treasury an automatic institution and practically to transfer its powers to the national banks would be worse; for it is impossible to see how any concerted action could be taken by these banks to protect the country (as a central government bank would do by increasing the rate of interest or by supplying money at moderate rates) if such a course proved to be contrary to their interest. They are, after all, money-making concerns—not public institutions—keenly competing against one another, and they cannot be forced to coöperate in any way that may injure their own business. There must be some power capable of taking an unselfish and larger point of view, for otherwise the country would be without any financial protection whatsoever. This function must be left for the time being to the Treasury, which, by increasing or decreasing the rate at which it deposits the government funds in the banks, can put on the brake to a certain extent and thus protect the country and its gold.

It is to be feared that any scheme which attempts to establish a concentration of control of note issue by the national banks and to create a joint guarantee of such notes will fail of adoption or will not work, in the long run, for the reason that each individual bank will be unwilling to submit to control or interference, and that the conservative banks will sooner or later feel that they are shouldering the burden for the less careful sister institution, which, if it fails, would inflict losses, to be borne by the joint guarantee fund contributed by all the banks.

The second bill which has been introduced meanwhile is the bill of the House Committee on Banking and Currency, which urges that authorization be given to any national bank to issue unsecured notes to the extent of 25 per cent of its capital, on paying a tax of 3 per cent, and an additional 12½ per cent on paying a tax of 5 per cent. This bill is undoubtedly an improvement on the proposition of the bankers' association, as through the higher tax there is more probability that the notes would be redeemed from time to time, since it would pay the banks to keep even the lower-taxed notes in circulation only as long as money is worth at least 4½ per cent. The rising scale, however, previously recommended by the Chamber of Commerce appears to be the safer plan, as with the almost stationary rate of 6 per cent for commercial paper, some of the country banks might otherwise be tempted to keep the lower-taxed notes outstanding nearly all the time. This, instead of elastic circulation, would mean increased circulation, which is not needed. But the chief objection to this bill and all similar recommendations is that it is a wrong principle to allow any bank giving unsecured commercial credits to issue unsecured notes. Besides, if a bank is allowed to issue, as a net result, about 28 per cent (37 per cent less the 25 per cent reserve) of its capital in unsecured notes, does it not simply mean that the bank, on paying a certain tax, may infringe upon its reserve to this extent? Should we not through such a measure place our national banks on a less conservative basis than they were heretofore, when they were not allowed to issue unsecured notes? Undoubtedly our system would gain in elasticity, and the guarantee fund might grow to take care of the notes of many a bank that might fail, perhaps just in consequence of the greater latitude offered to it by the present bills, but the principle remains bad all the same.

I strongly believe that banks issuing unsecured notes which are to pass as the people's money should be restricted to buying paper that is endorsed by other banks or banking firms, and that they should be restricted also as to the kinds of loans to be made by them; in short, they should not be allowed to take the same risks as every general bank or banking firm.

To meet, however, the needs of the hour it might be advisable to authorize the banks to issue notes, on paying a tax as proposed by this bill, but to secure these notes by a deposit of paper bearing at least three *bona fide* signatures, of which at least two would have to be those of banks or bankers.

This course would commend itself for several reasons.

1. It is more conservative and would make the banks and the notes safer.

2. It would force the banks to apply the money to be received from additional circulation to the purchase of commercial bills; it would prevent the money from being used directly for stock-exchange loans, as it could be under the present bill.

3. It would further the creation of modern paper, since, if such a law were enacted, modern paper which could be deposited would be taken in preference by the banks.

4. Certain committees would have to be appointed in every

reserve and central reserve city in order to scrutinize the bills deposited as security by the banks. These committees might be the predecessors of future local committees of a central organization.

5. We should lay the foundation to modernize our financial structure, a foundation that would carry in itself the elements of a central system built up on the trade, commerce, and industry of the country, an end which at present is far out of our reach.

The scope of the issue of secured notes can be safely enlarged from time to time, especially since a guarantee fund of secured notes would grow rapidly with comparatively few losses, while the bill of the House committee would be limited in its scope, and would be only a makeshift, endangering the safety and soundness of our currency.

Whether a central bank will be eventually owned by the national banks is impossible to foretell, nor can it be predicted whether the business of accepting and rediscounting will become the domain of the trust companies and the general banks, or whether new discount companies, like those in England, will be started for this purpose. It is, however, not beyond the bounds of imagination that a wholesome line of demarcation between the business of national banks and that of other financial institutions might gradually be reëstablished through such a development. Such paper could eventually be admitted also as collateral against the deposits of Treasury money.

That a central bank is the ideal solution of the difficulty and that it must finally come—though, perhaps, we may not live to see it—is my firm belief. None of the reasons advanced against it are tenable.

It has been argued that a central bank would be dangerous, as, in fact, it was in the past, because it might become the tool of politicians, and it has been frequently stated that "we do not want politics in business." But the powers which the

Secretary of the Treasury, a political officer, must exercise now are much vaster than those that any single officer of a central bank would ever enjoy, and these officers could be appointed in such a way—for instance in part by the government, by the national banks, by the courts, by the chambers of commerce—that the constitution of the board would be taken entirely out of politics. Are we not unduly depreciating ourselves by saying that we should not be able to find a set of business men of sufficiently high standing to form the central and local boards of such a central bank, and that we could not secure salaried officers competent to fill the post of managers of the central bank and of the branch offices?

I think that we are greatly mistaken if we believe our country so entirely different from all others that we should be obliged to continue to do the opposite of what is done by them, while the system of all other important nations has proved to be excellent, and ours has proved to be defective.

We have reached a point in our financial development where it is absolutely necessary that something be done to remedy the evils from which we are suffering, and it would be a thousand pities if our legislative bodies did not meet the situation. Let us, however, be careful clearly to recognize the cause of the evil before we act, so that we may not be found repairing the roof while the foundation is rotten.

Meanwhile, there remains important work to be done by the banking community itself, without any aid from Washington. At present our bankers look with scorn on rediscounting and accepting American bills. They should recognize the fact that these two branches of business are not only most legitimate, but most necessary for the nation's development.

NOVEMBER 12, 1907

II

A PLAN FOR A MODIFIED CENTRAL BANK

THE appalling panic which we have experienced during the last few weeks will do more, I suppose, to bring home to the public the absolute necessity of a change in our present banking and currency system than all the efforts that have hitherto been made to warn the nation of the imminent danger. It is to be expected that Congress will take some action on this question at its next session, but it is sincerely to be hoped that it will not follow the line of least resistance by adopting some paltry palliative, but that the question will be approached in a bold and broad spirit.

As I tried to prove in a previous paper on "Defects and Needs of Our Banking System," which *The New York Times* published in its Financial Supplement in January last, nothing short of a modern central bank will effect a final solution of the problem, but, as was also indicated in that paper, we are still so far removed from the fundamental conditions which would have to be created in order successfully to establish a central bank on the European basis that the attempt to take so far-reaching a step would involve material and harmful delay.

There are grave objections, however, to the scheme, advocated by so many, of creating an emergency currency by permitting each national bank independently to issue unsecured notes up to a certain percentage of its share capital, subject to a tax sufficiently heavy to insure the prompt withdrawal of these notes when times again become normal. If issued individually by each national bank, without a joint guarantee by all the national banks, such notes would add a new element of danger in times of panic.

Let us imagine what would have happened during the last few weeks when one of the national banks became somewhat involved, if notes of this kind had been outstanding. It stands to reason that the panic which caused a run of the depositors would have been carried into the ranks of the noteholders, and it might easily have intensified the distress by creating a general lack of confidence and wholesale discrimination against national bank notes, thus aggravating the general hysteria and increasing the withdrawal and hoarding of legal-tender currency as well as gold. It is, moreover, not at all improbable that the emergency notes of this bank and those of a majority of the other banks would have been in circulation before the real pinch came, as a great many people thought that the culminating point had been reached when, as a matter of fact, the crisis was only beginning.

Further, it is bad practice to allow a bank to issue unsecured notes, which are to pass as current money, against investments in single-name commercial paper or against loans of all kinds, as, for instance, in this case, on inflated copper and bank stocks. No European central bank would be allowed to proceed in this way. There are strict regulations as to the loans which these note-issuing banks are permitted to make; and as to their purchases of commercial paper additional guarantees (generally three good signatures) are required.

It is very doubtful whether the stronger national banks would consent to a joint guarantee by all the national banks for the entire amount of unsecured notes issued by the national banks. This could be done safely only if they could exercise a material control over their sister banks.

As a way out of the difficulty, the following plan is suggested —a plan which does not purport to cover the situation fully, but embodies a general sketch of what might possibly be tried. The scheme adopts some of the good features of the European system, while it seeks to avoid those parts of the European machinery which could not well be adapted to our present conditions.

It is proposed to create at Washington a bank, to be called hereafter the Government Bank, endowed with a capital of from $50,000,000 to $100,000,000, possibly paid up only in part, the share capital to be owned, if feasible, half by the government and half by the national banks, and the management to be in the hands of a salaried president or presidents, who are to be appointed for an indefinite period by the board of directors. The board of directors is to consist of delegates of the various clearing houses of the central reserve and reserve cities; the Secretary of the Treasury and the Comptroller of the Currency are to be members *ex officio*, and some additional directors are to be appointed by the stockholders, by the Supreme Court, and by the chambers of commerce of, let us say, New York, Boston, Philadelphia, and Chicago.

This is only a rough outline, susceptible of easy modification, intended merely to show how it is possible to create a board which would be independent of politics, which would comprise men of business knowledge and experience, and which, by its composition, would afford a reasonable guarantee that it would not be swayed by selfish motives in its actions.

The Government Bank would receive the Treasury's moneys, and the deposits of these moneys with the national banks would in turn be made by this bank. The Government Bank would have the right to issue legal-tender notes, not to exceed a certain multiple of its capital and its holdings of gold or of gold notes. The bank would, in the main, be limited to transactions with the clearing houses of the various cities of the United States and with the clearing-house members.

The Government Bank would be allowed to deposit moneys with the clearing-house institutions and national banks in the country against collateral, taking United States Government securities at 90 per cent of their market value, municipal securities at 80 per cent of their market value, and railroad bonds at 60 per cent of their market value. (The percentages above given are again only illustrative of the way in which government moneys, through the medium of the Government

Bank, could safely be put out against good securities on a plan similar to the European mode of handling government moneys.)

The bank would establish a general rate of interest for such deposits, such rate to be modified from time to time, very much as is done under like circumstances by the European government banks.

The bank would be allowed to advance money against clearing-house certificates of the banks of the central reserve and reserve cities of the United States.

It would further be allowed to buy paper running for a period not to exceed three months, made out in dollars or in sterling, francs, or marks, such paper to be strictly commercial paper and to bear at least three signatures, of which one must be that of a well-known bank, trust company, or banker. The privilege of buying such foreign paper is proposed in order to enable the Government Bank to accumulate a reserve of long bills having a gold basis, as is done by the European government banks. Such bills would be used to meet and to counteract, as far as possible, demands for gold which might be made upon us from time to time by other countries.

The authority for the Government Bank to buy three months' dollar paper, also bearing at least three signatures, including a bank's or banker's endorsement or acceptance, is added for the purpose of encouraging the creation of such paper, the lack of which is largely the cause of the immobilization of the resources of our banks.

It would probably suggest itself that a limit be set to notes issued tax-free by the Government Bank, and that a penalty be paid for notes issued in excess of this limit.

The general scheme as roughly outlined above has this advantage, that the control of the clearing houses over the individual banks would be strengthened, while it would, on the contrary, be weakened through the general emergency-currency plan. The clearing house would, as a matter of course, examine the collateral against which a national bank proposed to take out currency from the Government Bank by means of the clearing-house certificate. The clearing house would thus be able, to a certain degree, to prevent the moneys so received from Washington from being used for any but strictly legitimate purposes.

The clearing-house committee would have the right, but not the duty, to issue such certificates, and it could, through this power, hold a check on those institutions which it might regard as not sufficiently conservative. Moreover, the clearing-house committee would pass on the question in general whether or not it would be well for the community to issue additional currency.

The idea that the issuing of clearing-house certificates in itself implies the existence of a crisis would soon disappear, and before long the general public would be as little excited by it as is the German public when the limit of the amount of notes which may be issued without paying a tax has been reached. The issue of clearing-house certificates would mean, in general, that it is time to go slow, but it would not necessarily imply the imminence of a panic.

The scheme as proposed above would have the further advantage that clearing-house certificates, which now merely allow the banks to draw on their reserves, without increasing the currency, would serve in future as a means of providing additional currency, and while clearing-house certificates now materially increase the difficulty of settling the debits and credits between the various cities, they would, if used in the way proposed above, facilitate the intercourse between the cities. The Government Bank would act as the clearing house for the clearing houses.

It is not beyond the bounds of imagination that local boards for branches of the Government Bank in the various cities could be established, taking the clearing-house committee, or some members thereof, as a nucleus around which some other independent members might be added. It is also possible that these agencies would receive moneys in one city in order to pay them out in the other, as is done by the Reichsbank of Germany. It is precisely in times of panic, when so much currency is absorbed by unnecessary shipments from one place to another, that it would be a blessing to have a safe mechanism to act as a daily clearing house between the cities.

There are, of course, many sides to this question which need further discussion and elaboration in detail. I have tried, however, to confine myself to the presentation of the rough outlines only of a plan which seeks to avoid all those aspects of a central bank which render it objectionable to many.

In the bank contemplated the composition of its board is a guarantee that we shall not have "politics in business," and the limitation of its scope of business eliminates all danger of selfish or speculative use of its moneys. At the same time we should be laying a broad foundation on which it may be possible gradually to build a modern financial structure.

This scheme will perhaps meet with opposition from the numerous small country banks which are not members of a clearing house, and which, of course, would prefer that each bank should have the right to issue emergency notes independently for its own account. It is to be hoped that selfish considerations will not prevail in the solution of the problem, which is one of the most serious the country has faced for many years. Moreover, it should not be difficult gradually to work out some device, by means of which each clearing house would be enabled to take care of the banks of the surrounding cities. Above all, even if the scheme embrace for the present only the clearing houses in larger cities, there can be no doubt that it would prevent any recurrence of the present situation, which practically means a temporary suspension of payments all over the country.

We need some centralized power to protect us against others and to protect us from ourselves, some power able to provide for the legitimate needs of the country and able at the same time to apply the brakes when the car is moving too fast. Whatever causes may have precipitated the present crisis, it is certain that they never could have brought about the existing outrageous conditions, which fill us with horror and shame, if we had had a modern banking and currency system.

With our present methods our "elasticity" depends principally on stock-exchange loans, while the most legitimate business, the purchase of commercial paper, causes a dangerous locking up of capital in single-name promissory notes, which under normal conditions cannot be resold.

My previous paper fully explained that this is exactly the opposite of the European and of any modern system, and that by modernizing the form of our commercial paper, and by creating a central bank, we should aim to transform our commercial paper from a non-liquid asset into the quickest asset of our banks. This change, however, is so far-reaching that it would take years of educational work to carry it out, while relief should come at once.

In creating a central bank with limited powers and in making clearing-house certificates the regular means of rediscounting and of taking out additional currency in times of scarcity of money—not a means to be used only as a last resort in a severe crisis—we should adequately meet the situation. To the single-name paper we should add the joint guarantee of the clearing-house institutions before making it the basis of our current notes, which, with the additional weight of the issuing Government Bank, would form a safe means of elastic circulation, based on the legitimate demands of trade and industry.

Incidentally, we should gradually extend the influence of the clearing houses and the Government Bank, not only over the finances of the whole country in general, but also over individual concerns, against the reckless financial management of which these bodies might feel called upon to discriminate.

Instead of giving vast and vaguely defined powers, properly belonging to a central bank, to one or two political officers—possibly without business training—and instead of putting the burden and responsibility on them alone, we should define the power and responsibility clearly and should associate with our political officers in bearing it a large body of our best-trained business men. This would mean a democratic, a conservative, and a modern way of self-government.

FEBRUARY 3, 1908

III

AMERICAN AND EUROPEAN BANKING METHODS AND BANK LEGISLATION COMPARED

I

A COMPARISON of European and American banking methods and legislation is so broad a subject that it cannot be fully dealt with in a single address. It will, therefore, be necessary to limit ourselves to the broad outlines of the subject. We shall endeavor to state the general basis of the banking business in Europe and to compare it with our own, and where European methods differ from each other in detail, we shall single out for the purpose of comparison that system which is generally acknowledged to be the most efficient. Furthermore, in speaking of Europe, we shall understand the term to mean primarily the three prominent financial powers,—England, France, and Germany.

Let us begin by establishing the line on which modern banking has developed. From the primitive method of bartering goods for goods, exchange gradually developed to the acceptance of an acknowledged standard or measure, be it the accepted value of an ox, a slave, a woman, a measure of grain, or a certain weight of metal. Those means of exchange which prove the most durable and, at the same time, are the handiest because, being the most precious, they absorb the least space, are finally evolved as the best measures of value. Thus gold and silver of officially certified weight and fineness have developed as the coin and currency of nations. The next evolution is that, instead of accepting and carrying about clumsy masses of metal coins, the owner is satisfied to accept a certificate of ownership of metal—the note. Here we see the first appearance of credit in the use of media of exchange. Credit means, literally, faith; it is faith in the bank or government issuing the paper representing the bullion. We reach a state of modern banking, however, only when to this credit, which still means payment for each transaction in coin or coin certificate, are finally added other bank credits, which become part and parcel of the banking system. This means that instead of paying by money only, the vast majority of the payments are effected through transfer of credits; it means payment by check. I need not dwell at length on this question of deposits and checks, as it has been fully dealt with in some of the preceding addresses. The check, however, is only one, although a very important one, of the factors that constitute a modern banking system; many other currency-saving devices which supplant the use and absorption of cash have to be added to render the system a perfect one. We must add a modern system of bills of exchange (by which we mean two- or three-months' paper drawn on banks or bankers or endorsed by them) well regulated by clear and simple laws. As the check acts as a means of transfer of cash credits from one owner to another, so the transfer of the acceptance of a bank is the transfer of credits on time; it is like the transfer of banks' interest-bearing certificates of deposit on time. We shall have to deal fully with this important question a little later. As parts of a modern banking system we must further add well-organized stock and produce exchanges and clear and simple laws regulating the administration of corporations, and the issue, the transfer, and ownership of securities. All these refinements of our business intercourse, if I may so call them, have the object and effect of minimizing the physical transfers of property, and of reducing to a minimum the dangers of such transfers by establishing well defined and generally accepted laws and regulations governing such transactions, by avoiding unnecessary payments (through clearings), by liquidating whatever balances remain to be settled with the smallest possible use of currency, and by concentrating in large centers all offers for purchase or sale, so that on a common meeting ground of buyers and sellers the exchange of properties can be effected with the least expense, the least risk, and the least delay.

To transform the unsalable individual part ownership or individual indebtedness into stocks and bonds having a wide market, and to standardize merchandise, is an important step in the development of this time, risk, and currency-saving device, without which modern banking is inconceivable.

We have to add one more factor and a most important one. The partial replacement of money by instruments of credit must needs bring about, as a logical consequence, the necessity of reserves of money to meet these credit tokens, to redeem which cash may of right be demanded. How large these reserves must be depends largely on the strength of the confidence—the credit—upon which the general structure is erected, and on the degree of perfection with which these reserves may be made available.

An ideal banking system is that which provides for the legitimate needs of a country at moderate rates with the maximum use of credit and the minimum use of cash, which checks illegitimate or dangerous expansion or speculation, and which avoids or minimizes as far as possible all violent convulsions.

We need not emphasize the fact that the European system comes very near accomplishing this ideal, while our system has proved palpably inefficient. Recent events have again brought it home to us that the richest and soundest country of the world went into a disgraceful state of temporary insolvency, while European nations, poor by nature and loaded down with much heavier burdens than we, have weathered similar storms without any such panic and wholesale destruction of property values. Let us consider, then, wherein our system differs from theirs, and let us see which component parts are missing in our machinery.

II

If we may anticipate our conclusions, we may say that our methods are completely opposed to those of European countries.

The European system aims at centralization, ours at decentralization. Europe believes in and has established a system of central banks, issuing an elastic currency which follows the requirements of commerce and trade and is based, more or less, on bills of exchange; while the United States has so far refused to reëstablish a central bank and persists in maintaining a system of inelastic currency issued by 6,500 banks. The European system is built on modern bills of exchange, which form the quickest assets; while in the United States, the rediscounting of paper by banks being practically unknown, the chief quick assets relied upon by the banks are call loans on stock-exchange collateral. Europe has a system of general banks with large capital and branch banks all over the country; we prohibit a similar branch-bank system, and prefer a network of 20,000 small independent banks and trust companies. Europe believes in a system of monthly or half-monthly liquidations of stock-exchange transactions, while the United States maintains daily settlements. Europe has succeeded in working out for each country clear, generally observed, and uniform laws, regulating all commercial and financial questions; while in the United States not only do the laws differ in the various commonwealths, but the underlying principles are not so clearly and so definitely laid down as abroad, and every now and then the basis of the business structure is violently shaken by some new interpretation or legislation, or temporarily upset and endangered by sweeping injunctions.

In order fully to understand the European system, it will be necessary to explain at the outset the importance of the bill of exchange in Europe in the financial intercourse among individuals as well as among nations. In the United States commercial paper is the old promissory note, it is a *bill*;

in Europe commercial paper is a *bill of exchange.* I think that I cannot more forcibly express the difference between the two. In the United States this promissory note is an investment, in Europe it is a means of exchange. If, in the United States, this promissory note has entered the bank, it usually remains there until it falls due; if a New York bank, under normal conditions, should try to rediscount such paper, it would create suspicion and distrust. This means that every dollar invested by a bank in American commercial paper, that is, every dollar invested to satisfy the most legitimate requirements of business, leads, without fail, to a locking up of cash in unsalable assets. We have been shown bricks of the time of Hammurabi, the Babylonian monarch, evidencing the sale of a crop and similar transactions, and I am inclined to believe that it was as easy to transfer the ownership of these bricks from one person to another as it is to-day for an American bank to realize upon its discounted paper, if indeed it was not easier.

Let us now observe the absolutely reverse method of the European countries. In Europe there are scores of banks and private banking firms that give their two- or three-months' acceptances for the commercial requirements of trade, or that make it their specific business to endorse commercial bills. A commercial borrower in those countries who does not get a cash advance will do one of two things: he will either sell to his bank or his broker his own three-months' bill, drawn on a banking firm willing to give him this credit; or he will sell the bill drawn by him on his customer in payment for goods sold to him, which bill may be subsequently passed on with the endorsement of the banker. Through the addition of the established credit of the acceptor, or by the various endorsements on the bills, the quality of the bill becomes such as practically to eliminate the question of credit and risk, and the conditions of the sale will depend only on the rate of interest. From being a scarcely salable promissory note, the ownership of which entails a more or less pronounced commercial risk, the paper has been transformed, if I may call it so, into a standard investment, the equivalent of which in cash can be easily secured at any time.

This prime constituent of the European banking machinery is entirely missing with us. Its existence is, however, most important. Without such paper, the government banks of Europe could not accomplish their work; and *vice versa*, the rôle which this paper generally plays in Europe's financial household is dependent on the existence of central banks. The two cannot be separated.

It is one of the main duties and privileges of the government banks to buy legitimate commercial paper, with bankers' acceptances or bankers' endorsements. As the government banks buy this paper, the circulation of the notes which they issue in payment increases, and on the other hand, as they collect this paper upon maturity and reduce their discounts, their outstanding circulation decreases. This means that they expand or contract according to the requirements of trade. However, this is not a mere automatic process. For as those intrusted with the management of the government bank see the necessity of exercising a restraining influence, they raise the rate at which the bank discounts, and in this they are generally followed by the other banks of the country. In the same way, if the government bank finds it advisable for any reason to discriminate against the paper or the securities of certain groups or individuals, general discrimination by the other banks will usually follow. It might be well to add that the European government banks are not limited to the purchase of paper, but that they also have the privilege of making advances within certain limits upon securities up to a fixed percentage of the market value, according to stated published schedules. The rate, however, at which such advances may be made, as well as the government bank's discount rate, is uniform for everybody and is, as a rule, so much higher than that of the general banks, and the restrictions as to the character of the securities on which the government bank may advance are so much more rigid, that in normal times the bulk of the business is done by the general banks. Only when the demand for money increases does the rate of the general banks begin to approach that of the government bank; but in that case the government bank will, as a rule, raise its rate, so as again to increase the margin over that of the general banks. The government banks consider themselves, more or less, as constituting the national reserve, ready to take an active part in the nation's business only in times of emergency. A distinction is, however, carefully to be drawn between the abnormal crisis and what we may call the normal emergency which arises regularly in consequence of certain economic developments, like crop movements or particular requirements for special industries at fixed periods, and which, as experience has shown, subside after a time as regularly as they occur. When these normal emergencies arise, the banks do not unduly raise their rate, but for the time being meet all the requirements at a given rate, and allow their circulation to increase, while the reserves go down. When the government banks anticipate, however, that more than a normal emergency will have to be dealt with, they continue to raise the rates in order to protect their reserves and to force liquidation, and in order to deter all branches of industry and trade from entering upon far-reaching new engagements.

The notes which the government banks are allowed to issue are limited by the amount of gold and bullion which must be held to cover them in full, or, as in Germany, up to at least 33 per cent. It would, however, lead too far astray to go into the details of these special regulations which govern the issue of notes in the different countries. It will suffice here to outline the general rule. Each government bank has a very decided interest in keeping its gold holdings as large as possible, and in preventing the gold from leaving the country.

If an augmented demand for money and credit accommodation increases the amount of notes outstanding, the government bank, by raising its rate, purposes not only to encourage a general contraction of business, and to force the general banks of the country to contract, but also to attract foreign money into the country. If England has a private discount rate of, say, 6 per cent, that is, if first-class commercial paper accepted or endorsed by banks can be bought on an interest basis of 6 per cent, and if at the same time, there is in France a discount rate of 4 per cent, it stands to reason that the big French banks and the French public will invest in English bills, and that French money will go to England. The same holds good, of course, as to German, Austrian, Russian, or Scandinavian bills. It is, for instance, well known that at present, while rates in Germany are high and in France comparatively low, hundreds of millions of German paper are held by the French banks.

The French banks would not buy the individual note of an English, German, Russian, or Scandinavian merchant whom they do not know; but they do know, and must know, the value of the acceptance or the endorsement of the foreign banks, which offer and endorse or accept this paper. They would not buy this paper, unless they knew that it could be rediscounted at any time through the existence of a central bank in the home country. None the less, however, the bulk of the business transacted by a central bank is only a fraction of the total business of the country, and is, in normal times, limited almost entirely to the purchase and collection of short bills. The mere existence of the central bank, however, enables the general banks to discount freely; and as everybody thus discounts freely, there is the widest possible market for discounts even without any active purchases by the central bank.

While we cannot attempt to give a full description of the working of central banks, it may be well to add that some, like the Banque de France and the Reichsbank, have hundreds of branch offices, spread all over the country, which, in Germany in particular, have developed an admirable system of collection and of transferring moneys from one place to another. It may also be interesting to note that, contrary to a widespread idea, the central banks of Europe are, as a rule, not owned by the governments. As a matter of fact, neither the English, French, nor German government owns any stock in the central bank of its country. The Bank of England is run entirely as a private corporation, the stockholders electing the board of directors, who rotate in holding the governorship. In France the government appoints the governor and some of the directors (*régents*). In Germany the government appoints the president and a supervisory board of five members, while the stockholders elect the board of directors. The German government receives three-quarters of the profits after the stockholders have received a dividend of 3½ per cent. Thus the central banks are independent of direct government interference, or there is a joint control by government and stockholders. But the government is the largest depositor of the bank, and is thus obviously, both for its own credit and for the welfare of the nation, vitally interested in maintaining its credit at the highest possible point.

The consequence of a broad bill market is that, whereas our banks keep against their deposits primarily call loans on stock-exchange collateral, a European bank or banker will keep against his demand obligations a large amount of banking paper, which he can sell at any time at the discount rate, without causing any such commotion as is created with us when call money is rapidly withdrawn from the stock exchange.

Call-money rates and their daily fluctuations do not directly affect European stock exchanges. Europe has developed a system of monthly or half-monthly settlements on its stock exchanges, which means that from one settlement to another, the amount of cash required by the stock exchange remains stationary. If, at the settlement, it develops that commitments on the stock exchange have increased, and that a larger amount of money is needed for stock-exchange loans under normal circumstances, so much more money will be withdrawn from the bill market and go into the stock exchange. If less money is wanted by the stock exchange, so much more will go into the bill market. We cannot dilate fully on the interesting question of the comparative merits of daily versus monthly stock-exchange settlements. It may, however, be said that if it is a saving not to settle each transaction by individually delivering and paying for each purchase and sale, but to pay and deliver only the balance of the whole day's transactions by one clearing (without which it would be impossible to deal in a million shares a day), then the saving would be still further increased if the clearings covered not only one day, but a whole week or a whole month. It might, however, be asked: Why not then clear only once a year? The answer is that, until the transaction is actually paid for, there is a risk that with wide fluctuations one of the contracting parties may not be able to pay the difference between the price on the day on which the business was concluded and on the day when it would be finally settled. That is the reason why settlements in England do not exceed two weeks, and why in New York they should probably not exceed one week, for which period some method of clearing the differences daily or of securing them by collateral might easily be devised.

The present American system of daily settlements, however, combined with the lack of a central bank and of modern paper, brings about the shocking conditions from which we are suffering. It is a fact that in Europe, where settlements exist, such wild fluctuations as prevail with us are unknown, except in our own securities.

Our much-maligned stock exchange is the scapegoat of the nation; if trade contracts, the surplus money from the Atlantic to the Pacific is thrown on the stock exchange, creating easy money and encouraging speculation in securities just at a time when speculation ought to be slow. If industry and trade thrive, and are in need of money, call loans are withdrawn from the stock exchange, and, the more money is required by commerce and industry, the more the stock exchange will be depleted. The usual consequence is our annual money panic, and a resulting violent collapse of prices of securities.

This obnoxious system of cash dealings is forced upon us as the result of our unreasonable usury law, which, although making it unlawful to take more than 6 per cent on time loans, is in reality the direct cause of an almost confiscatory rate being charged from day to day for weeks at a time. We shall dwell upon this law later. The fact remains that with a legal limit of 6 per cent for time money, and with the desire of the banks not to charge merchants a higher rate, and with the lack of any modern paper which we could offer to other nations, there remain practically only two means of relieving the stringency and of attracting foreign money. These are the utilization of foreign credit, through long bills drawn by our banks or bankers on Europe (and these could hardly be used during the last crisis in consequence of England's drastic measures) and incredibly high rates for call money, that bring about wholesale realizations and attract foreign buyers at our bankruptcy prices.

Banks have been blamed for the high rates and for having had so much money on the stock exchange. They are absolutely helpless with regard to both. How could a bank withstand a run, if it had all its money in unsalable commercial paper, and how is a bank to meet the demands made upon it otherwise than by drawing upon its quick assets, viz., its call loans? It is our system that is wrong from top to bottom; it is this and not the individual that is to be blamed in this respect.

The aggregate amount invested in trade and commerce must vary. Its grand total should be many times the amount invested in stock-exchange loans, which represent the securities carried for speculative investors. Our way of doing business may be illustrated by two adjoining reservoirs, a small one and a very large one. The small one represents the stock exchange and contains the call loans; the large one represents the general business of the country, as expressed by commerce and industry. In Europe they regulate the small reservoir by pumping water into it from the large one, or by withdrawing water from the small reservoir into the large one. In this way, the outflow and inflow in the large reservoir are scarcely perceptible, and there is no difficulty in regulating the small one. With us, we do the reverse. If there is a shortage of water in the large reservoir, we begin to draw on the small one and, in order to increase the water in the large reservoir by an inch, we empty the small one altogether or, in order to decrease the amount of water in the large reservoir by an inch, we fill the small one to the overflow point. Moreover, Europe can tap a third reservoir, the additional currency issued by a central bank, with which to regulate the large reservoir if it fluctuates more than a few inches, while with us no such final reserve exists. As a consequence, fluctuations of several feet appear to be inevitable and regular occurrences with us. It may be added that not for many years has the European reservoir shown such variations as this year, and we must sadly admit that Europe's abnormal rates were due largely to our own unbalanced conditions. Unable to regulate our own household and to use our own gold, we have accustomed ourselves to use and to abuse Europe, which suffers intensely from our lack of a proper system.

III

Let us now add a few words about European and American banks in general.

We have in the United States national banks, state banks, and trust companies, practically without any proper line of demarcation; they are all, more or less, doing a similar business, except that the national banks have the privilege and duty of providing currency against government bonds. In Europe we find the privilege of note issue restricted to the government banks, which are hemmed in by such regulations as to keep them out of speculative business or general commercial transactions. Whenever a note-issuing bank desires to enter upon general business, it has to abandon the privilege of issuing notes.

Outside of the note-issuing banks the only European banks that are regulated by law as to their investments and their way of doing business are the savings banks. For all other banks there is no government supervision, there are no laws as to their reserves against deposits, and no restrictions as to endorsing or establishing branch banks. On the contrary, accepting, discounting, and endorsing paper form the essence of Europe's banking, which is built up on a system of old established, very important general banks with large capital and with a network of branch offices and agencies all over the country, and in the centers with many branch offices in a single city. On the whole, this system of making large responsible banks and their branches the custodians of the people's money is preferable to our system of allowing a few, often irresponsible, men to get together, hire some ground-floor corner, fit it up in marble and bronze, and call it a bank, with a capital of $100,000, and often less, and a corresponding surplus paid in, not earned. Small banks constitute a danger, particularly so if they accumulate deposits which are out of proportion to their own resources. There is an old French and Italian banking rule that deposits ought not to exceed four or five times the amount of capital and surplus. This rule is certainly a wise one for a country with so imperfect a banking organization as the United States.

While Germany and France may claim the best government bank organizations, there has been too much concentration in the business of the general banks of these two countries. The German and French banks have accomplished a wonderful piece of work, but their system of "taking it all," being banks of deposit, discounters, acceptors, endorsers, brokers, and underwriters at the same time, is not free from danger. Not that there is risk of their getting involved, but there is too much elimination of independent firms, which constitute a valuable backbone, especially in times of need. In Germany, where this process has been most marked, there is a strong movement on foot to undo the harm that has been done.

The English system has, in this respect, so far proved the best, for the reason that, while they have large deposit banks with branch offices all over the country, they have kept these deposit and check banks comparatively free from commission, investment, underwriting, and kindred operations. In England the investment and the commission business remain mainly with the broker, while the contracting of large loans and the formation of syndicates is generally left to private firms, or if it is a question of South American, Oriental, or colonial loans, to the banks which confine themselves to business with these countries. Again, there are foreign-exchange houses and firms conducting exclusively an accepting and endorsing business; and finally, there are the big discount companies. One might say that every branch of these various enterprises is taken care of in an able and efficient manner in England; business is done at fair rates and at the same time substantial profits are earned.

In Europe the general banks are not required to hold gold reserves. Gold reserves are kept exclusively by the note-issuing central banks, which have outstanding demand obligations payable in gold.

We ought carefully to draw the line between a working reserve and a gold reserve. A general bank has no need of a gold reserve. But every general bank or financial institution ought to have a large working reserve against its demand obligations. Such working reserve, however, need not consist of legal-tender notes, but of such assets as can be quickly turned into cash credits; be it call loans, bank paper, British consols, or whatever can readily be made available in times of stress. In addition, the European banks generally have very large demand deposits, especially with the central bank of the country, and, of course, a substantial amount of actual cash, as it is required for the daily needs of the business.

But why should state banks or trust companies or national banks, if they happen not to issue notes, carry gold reserves? For their own protection they need strong working reserves, but, if it were not for our lack of a central bank and for the shortcomings of our Treasury system, why must they lock up legal-tender notes to such an extent?

In Europe the gold reserve and the emergency reserve of the country are kept and managed by the central bank. We have already shown how the government bank acts in protecting the country and in providing for its needs. Let us clearly understand that without the bank rate, that is, without the ability to regulate the rate of interest in times when the government bank's coöperation is needed its efficiency would be *nil.* A system of modern banking paper is absolutely necessary to establish this power of the bank, and furthermore, a credit so firmly established that the higher rate of interest will act as an inducement to invest and not as a breeder of distrust and an incentive to realize. A further requirement is a system of large and conservative banks that will coöperate, and which, as a matter of fact, cannot afford to abstain from falling in line with the general tendency initiated by the central bank.

With such a system, a panic like the one from which we are just emerging should be impossible. For no matter whence money is withdrawn, it would turn up in another bank. It is inconceivable that conditions would nowadays arise in either England, Germany, or France where people would lose entire confidence in all banks, government banks, and savings banks, so that actual hoarding and locking away of money would occur. Our worst hoarders, the banks and trust companies, would, under a European system, have no reason to lock up actual money, since they would be fully protected by accumulating a balance with the central bank. The unheard-of fact that during a scarcity of currency the banks, instead of disbursing their cash, begin to accumulate and actually to hoard currency would be an impossibility.

There are two different kinds of panics or crises with which a nation may have to deal. One is a domestic drain, created by strong domestic demands, degenerating into a panic by some catastrophe engendering the fear that the supply of money will reach an end. Such panics must be met by paying out freely and boldly. Bagehot says:

> A panic, in a word, is a species of neuralgia; and according to the rules of science, you must not starve it. The holders of the cash reserve must be ready, not only to keep it for their own liabilities, but to advance it most freely for the liabilities of others. In wild periods of alarm one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them.

And further on he says:

> It is not unreasonable that our ultimate treasure in particular cases should be lent; on the contrary, we keep that treasure for the very reason that in particular cases it should be lent.

Another kind of panic may arise through a drain from without. Such drain must be met in modern countries by increasing the rate of interest until the tide has turned, until the creditor finds it more profitable to leave the money where it brings attractive interest than to withdraw it. Both kinds of panics have been successfully met, or have been entirely averted, in Europe by central banks and by a firmly established credit. Germany, for instance, without such a system, would now be in the midst of a panic; but she has safely avoided it, in spite of her being by nature a poor country, while we, nature's spoilt children, need only be wise to be rich and safe.

As it is, neither can we protect ourselves by a discount rate, there being no discount system, no central bank, and no legal rate beyond 6 per cent; nor can we meet an internal panic because, irrespective of other shortcomings of our system, it forces each bank to look out for itself and to try to draw away the cash from the others, in order to increase the amount in its own vaults, thus aggravating the panic. While the only way to meet a panic should be to pay freely, any bold action is paralyzed by the frightful thought that there is no way of creating additional currency, and by the knowledge that, if the drain continues, there are no means of preventing wholesale individual failures unless general suspension of cash payments is adopted. While one thousand millions of dollars were lying idle in our banks and trust companies as so-called reserves, that is, as the final resort in case of need, this money, by virtue of the law, could scarcely be touched! What, then, is the use of such reserves, if they are not available in such times, and if, even in contravention of the law, they could not be used by one bank without fear of being ruined unless all banks agreed to use them freely? And as it is impossible, even without such a law, to make all banks act in the same bold way, it follows that reserves should be concentrated, as they are in Europe, and that while the banks may be asked to coöperate, they must be governed in this respect by one central organ.

The question of Treasury and government-bond secured bank notes has been so fully and so ably dealt with by Mr. Hepburn in a preceding address, that I can limit myself to the hearty endorsement of what he said in this respect.

The net result of our system is that immense amounts of gold and currency are wastefully locked up, and that, in spite of our immense gold treasure, which is four times as large as that of England, and notwithstanding our enormous *per capita* circulation of thirty-five dollars, we suffer almost annually from acute scarcity of money.

If we only had the means energetically to contract our currency, and to use our gold in a scientific and a practical way, we should have gold and currency enough to meet any panic. As it is, the amount of notes outstanding is about stationary in times of activity or stagnation alike, while as a consequence the rates for money vary between zero and 200 per cent. In Europe it is the reverse; rates are fairly stationary and the amount of notes outstanding contracts and expands. With a cash balance of $260,000,000 during the recent crisis, our government had to incur new indebtedness to enable and to induce the banks to issue additional currency. Within three months the circulation increased through this artificial process by eighty million dollars, but the government had to lose about $1,000,000 of the people's money to reach this result. On the other hand, the German Reichsbank issued in one week, at the end of last December, M. 320, 000,000 and the government received a 5 per cent tax on this issue, which is borne by those who received the money. These notes returned to the Reichsbank within less than three weeks.

Our present system of maintaining and selling government bonds on a basis so high that only national banks can buy them results in constant inflation of our currency by about 75 per cent of the amount of new government securities issued from time to time. Inflation with practically no contraction! It would be cheaper and more straightforward were the government, instead of issuing interest-bearing government bonds, to issue new greenbacks. It amounts to the same thing, and the government would in addition not lose the interest.

Furthermore, our one-man-power system of the Treasury is contrary to European ideas; it is harmful to the country and unfair toward the incumbent of the office. While our generation has been particularly fortunate in seeing this office occupied by honest and able men only, the danger remains, nevertheless, that this vast power may one day be vested in less desirable men. Besides, the laws governing the functions and powers of the Secretary of the Treasury are old-fashioned, in parts too loose and in parts too extreme, and not clearly defined, so that even under the same President we find a radical change from one method to another, according to the individual interpretation by the incumbent of the office.

This lack of continuity is injurious. Europe does not give such vast and arbitrary powers to one single political official, holding office for a comparatively short time only, and often without proper business training. On the contrary, the powers, clearly defined and properly restricted, are vested in a permanent non-partisan body of business men of the highest standard, thus constituting a system which insures clear legal conditions, safety, and continuity.

IV

A similar difference exists between the United States and Europe as to general legislation governing banking transactions and corporations. In dealing with these questions it is not my intention to accuse anybody or to excuse anybody; the only object of this investigation is to explain certain fundamental shortcomings of our system.

Modern banking is built upon gold—and confidence. The question of how to estimate working reserves, business risks, and profits, as well as the general valuation of securities, all these are indissolubly interwoven with the other question of how firmly established is the confidence on which the whole structure rests and how far this confidence is liable to be shaken in normal and in troublous times.

The basis of confidence is an immutable belief in the continuity of political and social conditions, which are held to be safe and sacred. There must be faith in the continuity of the form of government, in the continuity of the legal status, and in the fair observance of law by government and governed alike. There cannot, however, be confidence in the continuity of the laws until they rest on a broad, equitable basis, and are fairly uniform over the entire country. There is nothing so harmful and so dangerous as the existence of two laws, the one a written law, unenforced and often impossible of enforcement, the other a customary law, which stands unchallenged for generations and which the written law cannot override, often because the latter, enacted in haste or hate, is incompatible with reasonable business usages and necessity.

Just and uniform laws, universally observed and equably enforced, imply wholesome government regulation. Loose or extreme laws that cannot be observed and that, therefore, are not generally enforced, but that may be suddenly and spasmodically enforced according to the whim of the people or of the party in power (yesterday a dead letter and to-morrow a firebrand), imply anarchy or autocracy. In financial matters Europe has advanced far in attaining a condition of law and order, while we have made too little progress in that direction.

To cite only a few instances:

If the full taxes on capital, at present about 1.68 per cent, were exacted and paid, no capitalist could remain in New York.

If banks did not over-certify, our financial centers would have to stop business.

If it had not been possible to pay rates far exceeding 6 per cent for time loans, it would not have been possible a few weeks ago to draw so much gold from Europe, where money rates were above 6 per cent, and the catastrophe would have been still worse than it was.

But, we venture to ask, why is it necessary to force people to evade the laws in order to carry on business?

Among the important laws that have a distinct bearing on the banking situation, and that are in great need of revision, I should specify the following:

In the first place is to be put the usury legislation of our separate States and especially of New York. The usury laws in Europe, where they exist at all, apply only where the borrower is in dire distress when seeking and accepting a loan, and where the individual or corporate lender knowingly profits from his helpless situation when exacting usurious rates. Usury can be judged only in the light of the surrounding circumstances; and usury laws in Europe generally apply only to individuals. Our law, which prevents solvent firms of bankers, merchants, manufacturers, or brokers from contracting for money on time at more than 6 per cent, implies not only undignified tutelage, but unsound business judgment. The recent crisis has shown that it was not taking advantage of people in need to give them money on time at over 6 per cent; on the contrary, it would have been a blessing, and in many cases their salvation, if they had been able to receive the money at even a much higher rate. This unsound and completely indefensible usury law is, however, the reason why we must have daily settlements, and in this and other ways it indirectly leads to frequent convulsions of our money rates.

Secondly, the lack of a modern system for discounting commercial paper in the United States is due to the want of uniformity and precision in the laws governing bills of exchange and bankruptcy. This uncertainty as to procedure forces us to prefer the well-defined promissory note— however unsalable—to the business of accepting and endorsing commercial paper at the low commissions customary in Europe. Furthermore, since our commercial business is chiefly financed by the national banks, it is a foolish regulation that prevents their endorsing or accepting such paper to any extent, in order that they may carry out the purely secondary object of issuing bank notes.

Another difference between Europe and America that affects the banking business is the regulation of the issue of securities.

Stock watering, that is, capitalization of earning power and of goodwill, is permitted in England and France, while it is not allowed in Germany. While, personally, I prefer the German system, it is a mistaken idea to think that the capitalization of earning power necessarily means taking advantage of somebody. If the German sells at 200 per cent an industrial stock paying 10 per cent dividend, it amounts to the same as if the English had sold at par twice the amount of shares, on which a 5 per cent dividend is paid. But whether we adopt the one system or the other, it is of the first importance that the public should be fully informed as to the real value of the stock which it acquires, and that the law should be clear and definite in its terms, and equal rather than erratic in its enforcement.

In Germany the law makes all public offerings of securities and applications for listing on the stock exchange dependent on the publication of a full prospectus. This document must contain all facts of importance concerning the security offered and must be submitted to, and approved by, a state commissioner. Anybody withholding information, or furnishing wrong and misleading information, is criminally liable. At the same time, the law requires that balance sheets be published regularly, and where the issue deals with a new flotation the prospectus must state clearly the value and the price of the properties transferred to the corporation at the time of its incorporation, and in certain cases also the names of those from whom they were bought.

We come finally to one of the most important of the subsidiary points affecting our banking system, namely, the relation of the directors to the corporation. In most of the European countries, particularly in Germany and France and, to a certain extent, in England, this relation departs radically from our custom. The French and German corporation is managed by a board of directors and salaried managers. The latter are not members of the board, as is the managing president with us. The board of directors in Europe supervise the managers, who have to report to the board about their acts and proposed acts, in order to secure their sanction. The rule is that both the managing officers, whose fixed salaries are comparatively small, and the board of directors share in the profits of the company. The stockholders ordinarily receive the first 4 per cent, while of the surplus of over 4 per cent a certain proportion goes to the managing officers and their staff and to the board of directors. As the corporation grows, the percentage going to the directors and the managers is frequently modified to whatever the shareholders consider a fair compensation. The net profit of the forty-five important German banks for 1906 was M. 231,000,000. The aggregate capital of these banks was M. 2,198,000,000 with a surplus of M. 542,000,000, making their total capitalization M. 2,740,000,000. Of this net profit about M. 200,000,000 were paid out; about one-seventh, viz., M. 28,000,000, was paid to the managers and staff and to the directors, while the remaining six-sevenths, being M. 171,000,000, were paid to the stockholders, being an average dividend of 8.07 per cent.

The underlying idea is a very different one from our own. The European maintains that, in order to hold any one liable in case he does not perform his duty, one ought to pay him if he does. In Germany, for instance, if a director does not act with what would be deemed ordinary business prudence, and if he neglects his duties, so that the company suffers loss, he is made personally liable. In the very rare cases of bad bank failures which Germany has witnessed, like that of the Leipziger Bank,—which, however, owing to Germany's admirable system, passed by without any panic—the directors, among whom were men of many millions, lost all they possessed.

While the law is thus very rigid, it does, on the other hand, not require the director to be anything more than honest, or to do anything more than use the utmost possible care. But the board members in a bank, who receive quite a large income through their share of the profits, realize that they must in turn devote a good part of their time and energies to the interests of the bank. All corporations, like the big shipping lines, the industrial concerns, and the insurance companies, are run on exactly the same plan. As a result, the so-called dummy director, so familiar to us, does not exist, because every director is materially concerned in seeing to it that the interests of the company are fully safeguarded at all times, and that no one director or manager receives any profits that might be determined to the corporation; while at the same time this system makes the directors disinclined to consent to over-capitalization.

With us, on the other hand, the laws and usages regulating the relations of director to stockholder need much modernizing. We do not pay our directors, for ten dollars or so per meeting cannot be considered a remuneration. Under the old system it was considered good style to be on the board of a bank as it was to be on philanthropic, religious, or educational boards; membership was, in fact, largely a social function. Or, on the other hand, some individuals were willing to join a board without any compensation, because it was their own business that they were managing; e. g., their own railroad, for which they had to supply the wherewithal themselves, and the territory of which they had to open by taking up farming or mining or by starting other industries. In such cases they sometimes made money and sometimes suffered heavy losses; but on the whole, it was this system of directors, as chief stockholders and ever active prospectors, assuming large risks themselves, that developed the country and made it what it is to-day.

In the course of time, however, as the corporations grew in size and number, directorship ceased to be a social function, and the corporations ceased to be the property of a few. They became the property of a large community of stockholders, and the directors, from being majority stockholders, slowly became trustees.

With the evolution of the modern conception of trusteeship has come the present tendency to endeavor to tie the director hand and foot and to hold him liable if anything goes wrong with the corporation. But let me ask, what right has one shareholder substantially to say to the other: "Go on the board, work for me, worry for me, give your time and spend your energy; I shall not pay you for it, but I shall hold you strictly accountable if anything happens to my company. If you chance to have a business of your own, and if you find any time left for it, be very careful not to do any business with my company. Leave that privilege to me. Because you work for me, you lose that privilege; and because I do not work for you—I retain it." That is virtually the present attitude of the American stockholder and to a certain degree the legal status of the director. Let us do as the Europeans do, let us remunerate our directors in proportion to the dividends they earn for us, and then we shall not only have the full right to hold them liable and to ask them to give up certain privileges, but we shall at the same time have greater certainty that every director will be careful to do his best.

Banking, like almost all other commercial transactions, is in reality an insurance business. For each risk, we ask and receive a premium commensurate with the hazard of the transaction. In a city built on volcanic ground the insurance premium is high. Bankers' profits in America are higher than in Europe; but they must be high so long as, for lack of modern banking methods and of uniform and well-established laws, we live financially on volcanic ground. We have just passed through a pretty lively earthquake, and the losses which wiped out the profits of years show conclusively that the premiums earned were not too large in proportion to the risk. Do not let us blame the insurance company, but let us be doubly careful to build only in steel and stone and let us build on solid ground. For, luckily, in this instance it is within our power to transform that volcanic ground into a solid foundation.

We are apt to think that our problems are peculiar to us and that we must find our own way of solving them. If we had only realized that American and European history is being written with the same ink, that man is man, with similar virtues and similar vices on both sides of the Atlantic, we might have learned much from experience, and might have been able to avoid much amateurish and harmful legislation.

Germany also had many sovereign states which ultimately formed a union. In each of these states there was a different legal system,—German law, Roman law, Code Napoléon, and all kinds of local laws. Yet Germany organized a commission, which worked for twenty-five years and which finally completed a code of laws to govern the entire country. A uniform commercial code had, in fact, been created far earlier, and Germany has now for many years been enjoying the advantages of uniformity. With us, also, there are surely many questions, social as well as commercial, on which the East and the West, the North and the South, can agree, and on which uniformity of State legislation can be secured—if for no other reason than to avoid the much-disliked Federal regulation.

In Germany, Sweden, and Switzerland—the last of the countries to adopt a central bank—we find that obstinate opposition was long directed against the creation of such a central institution, chiefly by the then existing numerous banks of issue which feared lest their business might suffer. In each country in turn, the very banks that were forced to abandon the right of issue in order to become banks of discount and deposit acknowledge to-day that they have derived nothing but profit from the change, and that the central bank has conferred unalloyed benefit on the entire country.

V

While our investigation has disclosed the nature of the ideal, it has, at the same time, also made it evident that we are still far removed from this ideal; so far, in fact, that any attempt to reach it immediately would be futile. We can, indeed, advance only step by step, but I am convinced that we shall never attain the summit of our ambitions or reach a completely satisfactory condition until we have worked our way to a central bank and to the adoption of clear and equitable statutes. We cannot secure uniform laws promptly, but we can begin by modifying some of the laws mentioned above, which are incompatible with common sense, and by creating truly responsible boards of directors like those in Europe.

We cannot have an effective modern central bank, because there are no modern American bills of exchange, and we cannot create a sufficient amount of modern paper without a central bank. We cannot have stock-exchange settlements without the abolition of the usury law; but even after its abolition we must have a bill market before we can do away with daily settlements and call loans, based on these daily transactions. Nevertheless, every one of these changes will have to be effected some day, and it is all-important that each successive step in currency and banking reform be made with this end in view.

From this standpoint it is evident why neither the Aldrich Bill nor the Fowler Bill can be deemed to be a step in the right direction. Every measure is bad (1) which accentuates decentralization of note issue and of reserves; (2) which uses exclusively bonds as a basis for additional circulation; (3) which gives to commercial banks power to issue additional notes against their general assets without restricting them in turn in the scope of their general business, and without creating some additional independent control, endorsement, or guarantee; (4) which gives arbitrary powers exclusively to political officers, often untrained in business, and usually holding office only for a short period.

A central clearing house, with power to issue against clearing-house certificates notes to be guaranteed by the United States, would, in my judgment, form the best solution for the time being. The creation of a central clearing house with a capital of its own and with a limited dividend, the surplus revenue going to the United States, would leave present conditions undisturbed, and, while offering immediate relief, would at the same time form a sound basis for future developments. The plan would possess the following advantages:—

1. The clearing house would have its own gold reserve.

2. It would centralize the additional note issue and would therefore do better service in permitting legitimate expansion as well as in forcing effective contraction, which, with sixty-five hundred independent note issuers, is well-nigh impossible.

While additional notes issued by a bank mean an increase of deposits, which may perhaps be called any day or which, on the other hand, may remain forever, an advance by the central clearing house would be made to the banks for a given period, after which the money must be returned. It would, therefore, be safer for the banks, and would at the same time insure contraction after a certain time, as in Europe.

3. The central clearing house would be able to accommodate commerce and industry in times of need by accepting commercial assets, provided that they are recognized as legitimate and safe by the endorsement of the local clearing houses.

4. It would leave our national banks without any further independent note-issuing power, and would in this respect be beneficial; for additional note-issuing power should logically carry with it further restrictions as to their privilege of doing a commercial business, whereas their privileges in this respect should rather be increased.

5. Through the share in the profits reserved for the government, the latter would receive some return on the funds which it would deposit with the banks through the central clearing house, whereas at present the government does not receive any such return.

6. It would form a medium through which gold loans might be contracted with European government banks in a way similar to that by which transactions have been concluded between the Bank of England and the Banque de France.

7. If there were formed to supervise the management of the central clearing house a central board administered by salaried managers, as in Europe, and comprising business men, largely selected from the clearing-house committees, as well as political officials, it would eliminate the arbitrary powers which the Secretary of the Treasury is now called upon to exercise, and it would create a continuity of policy, which is most essential for the development of the country.

8. Finally, it would show that this country is able to produce a body of men as honest, as trustworthy, and as efficient as those into whose hands Europe has confided the care of its central banks. As the confidence in this body grows, as the banks come to feel its beneficent influence, the powers of this clearing house may gradually be increased, and thus from the joint endorsement by the clearing houses we may gradually gain our way to the endorsement and acceptance by individual banks, so that we may finally be able to develop a central organ which, safeguarded from political and from financial domination and rigidly restricted as to its scope of business, will place us financially in a sound and healthy condition and will cause us in this domain, as in others, to be respected as a modern and completely civilized nation.

APRIL, 1908

IV

A MODIFIED CENTRAL BANK OF ISSUE

A Suggestion for a Bill

PREFACE

I HAVE been repeatedly asked to show in detail, how I would construct the "modified Central Bank," the creation of which I have championed on various occasions.

It is in compliance with this request that I herewith submit the following draft of a bill.

In doing so I do not pretend to present a perfect legal document, nor do I claim that it could not be modified to advantage in many details. It is of minor importance for this preliminary draft whether the country shall be divided into twenty or thirty "bank association districts," or whether there shall be twenty or forty members on the board of managers. These eminently practical and political questions will have to be carefully worked out upon full consideration of all sides of the question. This draft of a bill merely purports to show the lines that such an act, according to my ideas, would have to follow.

There are, however, certain facts and fundamental principles which, I am convinced, must be clearly recognized and rigidly observed in dealing with this question. They are as follows:

First. The United States must finally develop some kind of a central banking system, giving the country an elastic currency based on modern commercial bills payable in gold: a system similar in principle, if not exactly alike in form, to those of the important European central banks.

Second. While this must be the final aim, our political, legal, and economic conditions preclude the possibility of creating at present an institution with powers and efficiency equal to those of the European government banks. In previous publications I have tried to point out the far-reaching preparatory steps that will have to be taken before the final goal can be reached.[1]

Third. We shall, therefore, have to be satisfied to advance slowly, fully realizing that what we create now can only be an initial step. *But it must be a step in the right direction, a measure which has clearly in view the final aim and which does not neglect any of the fundamental principles on which modern central bank systems have been erected in other countries*, and which have already stood the test of storm and stress.

Fourth. From this point of view no measure is acceptable:

(*a*) Which bases currency on long time obligations, like the Aldrich Bill.

(Short obligations not exceeding three months and payable in gold form the only sound basis for an elastic currency. Only by having daily maturing paper and by collecting or renewing it according to the requirements of the moment, can the Central Bank control the situation and meet its own gold obligations.)

(*b*) Which would tend still further to decentralize the power of issuing notes, and which would vest this power in banks doing a general commercial business. The issuing of notes must be centralized into a few organs, or, if feasible, into one organ—a plan, which will insure effective expansion and contraction of currency and concentration of reserves. Such a note-issuing bank, in order to be safe beyond question and in order to provide safeguards against any abuse of its vast power through favoritism or speculation, must be carefully restricted in its scope of business. (That is why we could not accept a bill like

[1] "*American and European Banking Methods and Bank Legislation Compared*," in the volume entitled *The Currency Problem and the Present Financial Situation*, New York: The Columbia University Press, 1908; also separately.

the Fowler Bill, which practically would create thirty to forty thousand note-issuing national banks, doing at the same time a general banking business, while the smallest and most speculative bank, through the proposed guarantee of deposits, would be as able to attract large deposits as the largest and most conservative bank. Such a measure, although the very antithesis of the Aldrich Bill, would be quite as much in contravention of well-established economic principles.) A note-issuing bank in this country should be exclusively a bank of the banks.

(*c*) No measure would be acceptable which vests the powers of a central bank in political officers alone, as is the case under our present system. That power, clearly defined, ought to be vested in political officers and business men combined, in a way that would render impossible any political or financial abuse.

(*d*) No measure would be acceptable which would allow the government or the banks to issue additional notes without creating at the same time a special gold reserve, composed partly of gold and partly of short term gold obligations. Without such a provision we should create inflation and cause a dangerous weakening of our present standard.

(*e*) A bank rediscounting with a central bank receives a loan for a given period, and upon this advance it may safely base its own commitments for the accommodations of its customers. The issuing of notes against its assets by a national bank means the creation of additional depositors who may withdraw their money any day like any other depositor. It is unsafe for a bank to accommodate its customers from resources which may be withdrawn at any time. This is a most important and fundamental point.

While carefully observing all the principles outlined in the foregoing, the bill, which is herewith submitted, would, if enacted into law, not interfere at all with existing business habits or institutions. For the time being, its effect would be nothing but the establishment of a central issue department with authority to emit additional notes against certificates of guaranty (twin brothers to the clearing house certificates) and against certain foreign bills of exchange. But this central issue department, or Central Bank, as I boldly call it, is endowed with all those inherent qualities, in a very embryonic form, which through gradual evolution may make it in years to come, if and as the people decide that they want it, a modern and effective central bank.

Nobody denies the fact that our financial machinery is old-fashioned and entirely insufficient. But—to use a metaphor—while our tracks have the wrong gauge, while our rails are too light and our machines too old, and while our lines are disconnected and lack centralization, we could not tear up the whole system at once, nor could we stop increasing our facilities necessary to meet the immediate needs of the country. A wise manager, however, will conceive a clear plan of the final shape that his railroad must take, and he will plan every detail of new construction so that it will be a useful part of the future system, and so that *it will lead toward the final goal instead of leading further away from it.*

As to those on whom the words "Central Bank" still act as a red rag on a bull, I ask them to study this bill carefully and without prejudice—if they can—and they will find not only that this central issue department is surrounded by so many safeguards as to make it more conservative than our present system, but that even Andrew Jackson, were he alive, would not be likely to oppose it.

A SYNOPSIS AND EXPLANATION OF THE BILL

The bill is divided into two main sections:

Section "A" deals with the organization of the Central Bank; Section "B" provides for the creation of twenty District Associations with power to issue "certificates of guaranty" to its members against collateral, specifically defined by the bill. The "certificates," which shall be the joint obligation of all the banks comprising such District Association, may be used as security for advances to be taken from the Central Bank by a member of the District Association.

The Bank District Associations are organized on lines similar to those of Mr. Fowler's Redemption Districts, with this difference, however, that the Fowler Bill makes it obligatory for every national bank to join a Redemption-District Association, and to participate in a general broad guaranty, without collateral, of notes and deposits of other banks; while the bill, as here proposed, not only makes it a voluntary act for each bank (state or national) to join the Association, but provides that the guaranty shall be limited to individual transactions, each of which will be secured by collateral carefully scrutinized in every case.

This would seem to be a more conservative and a more business-like proposition.

A commission of one-quarter of one per cent per month upon the face value of the "certificate of guaranty" is to be paid to the Association issuing the certificate by the bank taking out such certificate.

The powers of the Central Bank are practically limited to two kinds of transactions: it may deposit money or make advances against certificates of guaranty, at rates to be published from time to time; and it may buy certain short and long bills on England, France, and Germany. No bill purchased by the Central Bank and no advance or deposit made by the Central Bank may exceed a period of three months.

The power to purchase these foreign bills is necessary to insure contraction of circulation in times of ease, when the notes can be withdrawn from circulation and the funds of the bank can be invested primarily in foreign bills, easily to be rediscounted and turned into a gold reserve, to be released and used whenever circumstances call for it.

This is the method adopted by European government banks, and any currency legislation which neglects to provide for special funds to be exclusively reserved for investment and handling in a similar way, is unscientific and at the same time dangerous.

It is provided that the stock of the Central Bank shall be owned by the United States for the next ten years. In the eventuality that Congress should deem it advisable, after that period, to have the stock owned by the people, it is provided that the stockholders shall receive the first four per cent, and that of any surplus beyond this sum three-quarters shall go to the government, in consideration of its guaranteeing the notes of the bank, and one-quarter to the stockholders. This provision is suggested to meet the criticism of those opposed to a central bank, for fear that any group of capitalists might buy control of such a bank and use it for their own purposes.

The restrictions placed upon the bank as to the transactions upon which it may enter render impossible any abuse of power by engaging in any illegitimate kind of business, and the limitation of the income from the stock eliminates any inducement to buy the stock for speculative purposes. The stock would become widely scattered all over the country as a government investment (as in Germany, where a similar method has been adopted). It is proposed to create an additional safeguard by the regulations affecting the election of the Board and of the management of the bank. The Secretary of the Treasury, the Comptroller of the Currency, the Treasurer of the United States, six members of Congress, and the twenty Chairmen of the District Associations would be members *ex officio*. The stockholders (for the time being, the government) would appoint twelve additional members. This Board would appoint a salaried Governor of the Central Bank.

In this manner the danger of political domination as well as the danger of control by business men, singly or combined, is completely eliminated. Even the most vivid imagination, it is believed, will fail to find any menace in the modified form of a central bank, as here proposed.

A BILL

Providing for the Establishment of a Central Bank of Issue of the United States and for the Creation of Bank District Associations and for the Issuance and Redemption of Credit Notes Guaranteed by the United States.

BE IT ENACTED by the Senate and House of Representatives of the United States of America in Congress assembled, that

MAIN SECTION A

Section 1. There shall be established in the City of Washington, District of Columbia, a Central Bank of Issue of the United States, with a capital stock of one hundred million dollars.

Section 2. That the Central Bank have succession for the period of fifty years from its organization, unless sooner dissolved in accordance with the provisions of its articles of association, or by the act of shareholders owning two-thirds of its stock, or unless its franchise become forfeited for violation of law.

Section 3. That the stock of said Bank be subscribed and paid for and thereafter owned by the United States of America. Such stock shall not be sold by the United States of America for a period of not less than ten years, and, after the expiration of that period, only after a resolution of Congress permitting its sale.

Section 4*a*. That the Central Bank of Issue of the United States shall be governed by a General Council, consisting of forty-one members, of whom twelve members shall be elected by the stockholders of the said Bank. The Secretary of the Treasury, the Treasurer of the United States, and the Comptroller of the Currency, as well as the Chairman of each of the twenty National Bank District Associations, to be established in accordance with the provisions of this law, shall be members *ex officio* of the Council. Three members of the Council shall be selected by the Senate from among its members and three members by the House of Representatives from among its members.

Section 4*b*. The members of the Council shall hold office for one year, and until their successors are elected and have qualified. Shares of stock of the Bank held by the United States shall be voted in accordance with the directions of a Committee of both Houses of Congress, to consist of the members of the Finance Committee of the Senate and of the Committee on Banking and Currency of the House of Representatives.

Section 5. The General Council shall elect a Governor, who shall receive a salary of $..,000 per annum. He shall preside at the meetings of the Council and shall have general charge of the business of the Central Bank. The General Council shall also elect one or more Deputy Governors to act during the absence or disability of the Governor; their salaries shall from time to time be fixed by the General Council.

Section 6. The General Council shall create such other offices as may be necessary, and shall either appoint the officers and employees or designate the method of their employment; it shall fix the salaries of all officers and employees and direct the general policy of the Bank in comformity with the provisions of this Act.

Section 7. The Governor, Deputy Governors, and all other officers and employees of said Bank are hereby prohibited from participation in any syndicates or underwritings and from investing in stocks of any bank or trust company, or from incurring indebtedness in any form, except current bills for living expenses or mortgage indebtedness on a homestead actually occupied as such. Any violation of this provision shall be punishable by imprisonment for a period of not less than .. years and a fine of not less than $..,000 for each offence.

Section 8. The General Council shall appoint an Executive Committee, to which it may, in its discretion, delegate its powers. This Executive Committee shall consist of the Secretary of the Treasury, the Treasurer of the United States, the Comptroller of the Currency, and eight other members. Seven of the members shall constitute a quorum. The Executive Committee shall meet at least once a week.

Section 9. The General Council shall meet at least once in each month, and may be called in special session by the Governor of the Bank.

Section 10. The members of the General Council shall each receive as full compensation for their services the sum of $..,000 per annum, also necessary expenses while traveling on business of the Bank. Members of the Executive Committee shall receive in addition $..,000 per annum, as well as expenses.

Section 11. That at any regular or special meeting, the General Council may, by vote of no less than one-half of its members, issue demand notes of the Central Bank of Issue of the United States in the form of currency payable on demand. Such notes shall be secured by gold bullion or gold coin or legal-tender notes of the United States or by foreign bills, as hereinafter provided, or by certificates of guaranty of the Bank District Associations, as hereinafter provided. The Bank shall at all times hold an amount of gold, gold coins, or legal-tender notes equal to not less than one-third of the aggregate amount of currency notes outstanding.

The notes of the Central Bank of Issue of the United States shall be guaranteed by the United States of America.

Section 12. All notes issued by the Central Bank of Issue shall be payable on demand in lawful money of the United States, at the office of said bank in Washington, D. C., or at the option of the holder at redemption offices to be designated thereon, and when so redeemed and paid, such notes shall be canceled and destroyed.

Section 13. That the Central Bank of Issue of the United States shall have power to deal in gold and silver bullion; to contract for loans of gold at home and abroad, and, when necessary, to give acceptable security for their repayment, to open and maintain banking accounts in England, France, and Germany for the purpose of transactions connected with such bullion operations or with the investment in and the collection of foreign bills of exchange, as hereinafter provided; to make deposits of cash with banks in the United States, provided such deposits be secured by certificates of guaranty of the Bank District Associations, and to make loans secured by certificate of guaranty. Such advances, whether deposits or loans, shall be for a period not in any event to exceed ninety days, and the aggregate of advances against the certificates of any one District Association shall not exceed the aggregate capital and surplus of the Associations comprising the District Association by which such certificates are issued. All such advances shall be at rates to be fixed and published from time to time by the General Council.

The Central Bank shall have power to deal in, to purchase and to sell, with or without its endorsement, short and long bills payable in England, France, or Germany, such bills to run for a period not exceeding ninety days, and to bear the signatures of at least three responsible parties, of which one shall be that of a bank or banker in good standing. The Central Bank shall further have power to receive deposits of government funds without depositing security therefor, and to transact any and all government business that may be entrusted to it. The Secretary of the Treasury, the Treasurer of the United States, and disbursing officers of the United States in every branch of service are empowered to deposit government funds with the Central Bank, or for its account with its branches, agents, or correspondents (if any), without exacting security for such deposits, and such deposits shall be construed, and in the settlement of their accounts shall be allowed, as payments made into the Treasury of the United States.

The Central Bank shall have power to receive deposits from members of the District Associations and the members making such deposits may count the same as part of their lawful money reserve.

The Central Bank shall not loan upon, nor purchase, real estate except for its own banking quarters; nor shall it purchase securities of any kind, except bonds or other interest-bearing obligations of the United States, unless the purchase of such securities shall be necessary to protect the bank in the contingencies contemplated by and subject to the limitations of Section 5137 of the Revised Statutes relating to National Bank Associations, the provisions of which Section are hereby extended to the Central Bank of Issue of the United States.

Section 14. Notes of the Central Bank of the United States may be counted as part of their lawful money reserve by the National Bank Associations.

Section 15. Funds of the United States shall be deposited only with the Central Bank, and no security against such deposits shall be exacted.

Section 16. Notes of the Central Bank shall be received at par in all parts of the United States in payment of taxes, excises, public lands, and all other dues to the United States, and also for all salaries or other debts and demands owing by the United States to individuals, corporations, and associations within the United States, except interest on the public debt and in the redemption of the national currency. Said notes shall be received on deposit and for all purposes of debt or liability by every national bank at par and without charge of whatsoever kind.

Section 17. The net profits of the Central Bank, after providing for expenses, bad debts, and doubtful accounts, shall be applied as follows: An amount not exceeding twenty per centum of the net profits shall be annually placed to reserve until the reserve amounts to twenty per centum of the capital. Out of the balance of net profits, dividends shall, in the discretion of the directors, be paid on the capital stock to the extent of four per centum per annum. Of any surplus of earnings over such four per centum dividends, one-fourth shall be paid to the stockholders, and the remaining three-fourths to the United States Government.

Main Section B

Section 1. That upon the passage of this Act the Comptroller of the Currency shall immediately proceed to designate as the headquarters of Bank District Associations such cities of the United States (not exceeding twenty in number) as shall best accommodate and serve the banking business of the country; such Associations shall be consecutively numbered.

Section 2. That within thirty days after the designation of cities to serve as headquarters of the Bank District Associations the Comptroller of the Currency shall assign every bank (state and national) to one of the Bank District Associations, and thereupon the Comptroller of the Currency shall notify all banks that meetings for the purpose of organizing the several Bank District Associations will be held at their respective district headquarters at a designated place and on a given day. Membership in such Bank District Associations shall be voluntary and every bank taking part in such organization shall be entitled to only one vote, which shall be cast by an officer of the bank thereunto duly authorized by a vote of the Board of Directors thereof, such authorization to be evidenced in writing and under the seal of the bank.

Section 3. That the Association formed by the banks joining any such District Association shall be known as "Bank District Association No. —."

Section 4. That the organization of each District Association shall be perfected by the election of a Board of Managers, consisting of eight members, to serve as follows:

Two of the members for one year; two of the members for two years; two of the members for three years; and two of the members for four years.

The members so elected shall thereupon determine by lot the length of service of each member; each Board of Managers shall adopt rules for the proper conduct of its business.

Section 5. That thereafter on the first Monday in May of every year the banks of every Bank District Association having joined such District Association shall meet and elect two members to serve for a term of four years, to succeed the retiring members of the Board of Managers. Vacancies in said Board of Managers arising from any other cause than the expiration of a term of office shall be filled by the Board of Managers until the next annual election, when such vacancies shall be filled by a vote of the members of the Bank District Association in the same manner as vacancies through expiration. Special meetings of the members of a Bank District Association may be called by the Board of Managers on giving at least seven days' notice, or such of them, less than a quorum, as may attend any meeting duly called; and special meetings shall be called to fill vacancies in the Board of Managers where the number of such vacancies makes it impossible for the Board of Managers to obtain a quorum or to transact business. At all elections by the members of any Bank District Association, for the purpose of filling vacancies in the Board of Managers, each bank shall vote as prescribed in Main Section B, Section 2, of this Act.

After any member of said Board of Managers, excepting the Deputy Comptroller mentioned in Main Section B, Section 6, shall have served a full term of four years, he shall be ineligible for reëlection until he shall have been out of office for at least one year.

Section 6. That the Board of Managers, elected as prescribed in Sections 4 and 5, shall on the first Monday of June in each year select a ninth member, who shall thereupon become a Deputy Comptroller of the Currency, and shall act as Chairman of said Board of Managers. He shall give his entire time to the duties of his office and shall serve for one year; and his compensation therefor shall be six thousand dollars per annum, payable in monthly instalments. The Board of Managers, however, may increase said salary, provided that such increase be authorized by the District Association at its annual meeting.

The Chairman shall at any time cause meetings of the Board of Managers to be called at the written request of three of the Managers.

The Board of Managers of any Bank District Association may by the affirmative vote of seven members expel any of its members, provided that notice of intention to move the expulsion of a member, designating him by name, shall have been given in the call for the meeting. The officer of the Board of Managers charged with the duty of calling meetings shall, at the request in writing of three of the Managers, embody in any call notice of a motion to expel any member of said Board.

Any member of the Board of Managers may resign, and upon acceptance of his resignation and the election of his successor shall cease to be a Manager.

Whenever a member of the Board of Managers of a Bank District Association shall be a director or an officer of a bank member of said Bank District Association that has become insolvent or has suspended payment, or that is in default in any obligation to said Bank District Association, or when a Manager shall have been absent from three consecutive regular monthly meetings of the Board of Managers, unless said absent member shall, previous to such absence, have applied for and received by resolution of the Board of Managers a leave of absence for a longer definite term, not, however, in any event to exceed six months, he shall *ipso facto* cease to be a member of said Board of Managers. He may, however, be reëlected.

Section 7. That each Chairman of a Board of Managers shall, subject to the direction of the Board, have all the authority of the Comptroller of the Currency in respect of the supervision of the members of his particular Bank District Association, including the power to cause examinations from time to time to be made of any banks comprising his Bank District Association; and all the decisions of the courts affecting the office of the Comptroller of the Currency shall be applicable to the conduct of the Chairman of the respective Bank District Association. For the purpose of securing a uniform system of bank reports, all the banks shall make reports to the Comptroller of the Currency as now provided by law.

Section 8. That five members of said Board of Managers shall constitute a quorum to do business.

Section 9. That each Board of Managers shall have entire and sole charge of the organization and conduct of its Association, and shall elect and direct such bank examiners as the Board may from time to time deem requisite for the proper supervision of the banks within its district.

All compensations paid to the examiners in the several districts shall be in the form of stated salaries and shall be borne by each Association out of its general Guaranty Fund.

Section 10. That the Board of Managers of the several Bank District Associations shall meet at least once every month throughout the year at their respective headquarters. The day of said monthly meetings shall be the second Thursday in every month, unless the Board of Managers shall, by vote, select some other day.

The compensation to be paid to each member of said Board, except to the Chairman thereof, shall be ten dollars for each meeting and actual expenses.

Section 11. That every bank on becoming a member of a District Association shall pay into the Guaranty Fund of the District Association the sum of $1,000, and such annual contribution thereafter as the members of the District Association may at its annual meeting decide. Such annual contribution shall be uniform for all members of the District Association, and shall be not less than $1,000 for each year. The annual meeting shall also pass on applications for new memberships.

Section 12. Any bank, having an unimpaired capital of at least $50,000, and being a member of a Bank District Association, composed of not less than 100 national banks (being not less than 50 per centum of the total number of banks in said district), having an aggregate unimpaired capital of not less than $10,000,000 (being not less than 50 per centum of the total unimpaired capital of all banks in said district) may apply to the Board of Managers of its Bank District Association for the issue to it of a certificate of guaranty to be used by it as security for a deposit by or a loan from the Central Bank, as provided in Section A of this Act, and the Board of Managers of the Bank District Association may thereupon, in its discretion, after an examination of the condition of the bank, or in its discretion without such examination, and in any event only upon the conditions hereinafter set forth, issue such certificate of guaranty to an amount not exceeding the unimpaired capital and surplus of the bank making such application. Every such certificate of guaranty shall be secured by deposit of collateral security with the Bank District Association, which may at any time or from time to time require the deposit of additional collateral or of collateral of different character.

Every bank in making application for the issue to it of a certificate of guaranty must submit a full statement of the collateral by which it proposes to secure such certificate, and the Board of Managers of the District Association shall thereupon decide whether it will issue such certificate, and if so, for what amount and for what length of time and upon what other conditions, if any. Under no circumstances shall such certificates be issued to run for a period exceeding three months, nor for a face amount of such certificate of guaranty at any time exceeding the following percentages of the value of the collateral deposited with the Bank District Association as security for said certificate of guaranty, that is to say, 75 per centum of the face value of bills receivable (discounted commercial paper) or 95 per centum of the market value of United States Government bonds, or 85 per centum of the market value of such bonds of States or cities, or 75 per centum of the market value of such first mortgage railroad bonds as may from time to time be designated by the Secretary of the Treasury.

Section 13. That should a bank suspend payment, or be in default in maintaining the necessary margin upon its collateral, or be otherwise in any respect in default in any obligation to the District Association, the Board of Managers thereof may, without notice to the bank, sell the collateral for its account. The proceeds of such sale shall be paid into the Treasury of the United States in redemption of the indebtedness incurred by such defaulting bank against the certificate or certificates of guaranty.

Section 14. That every bank shall pay to its District Association, in respect of all certificates of guaranty issued to it, an amount to be equal to not less than one-quarter of one per centum of the face value of such certificates; on all certificates of guaranty, not redeemed after one month from date of their issue, an additional amount equal to one-quarter of one per centum, or such greater amount as shall have been fixed by the Bank District Association at its annual meeting, shall be paid at the beginning of each successive month. Such payments shall constitute a Guaranty Fund for the payment of all losses of the District Association. Any deficit arising in the Guaranty Fund through such losses shall be promptly made good by the members of the said District Association in the proportion of the capital and surplus of each member; the pro rata of each member for the ensuing fiscal year being fixed at the annual meeting. Members paying more than their pro rata shall be entitled to contribution against their fellow members. Amounts paid by members by reason of a deficit or of deficits in the Guaranty Fund shall be repaid to such members out of any recovery had in respect of the loss or losses by which such deficit or deficits were caused.

Section 16. That the fiscal year of the District Association shall close on April 30th of every year, and that the annual accounts of the Association shall be made up as per this date and shall be submitted to the annual meeting to be held on the first Monday in May.

Section 17. That any bank desiring to withdraw from the Association must give notice of its intention on or before January 1st, and, having given such notice (unless it be withdrawn and the withdrawal be accepted by the Board of Managers), the bank on payment of all liabilities to the District Association, including the surrender to the Bank District Association of all certificates by it issued to the bank, shall cease to be a member on April 30th following. Any bank so withdrawing shall be entitled to its pro rata share of the Guaranty Fund on the pro rata basis fixed for the last year during which such bank shall have been a member, after making due provision for all unliquidated engagements for which the retiring bank shall be responsible at the time of its withdrawal. All amounts so due shall be paid to the retiring bank, free of interest, on the 30th of April of the year following its withdrawal.

Section 18. That the Guaranty Fund may be invested by the Board of Managers in securities permitted by the laws either of the State of New York or of New Jersey, or of Massachusetts for the investment of trust funds of widows and orphans.

Section 19. That all salaries and expenses of the Association shall be payable out of the Guaranty Fund.

Section 20. That the Comptroller of the Currency and the Deputy Comptrollers, Chairmen of the Board of Managers of the respective District Associations, shall meet at least once every six months at such place as the Comptroller may designate, and such regular meetings shall be held on the second Tuesday of April and October in every year, unless the Comptroller and the Deputy Comptrollers by vote select some other day and month.

Section 21. That the Comptroller shall always act as Chairman of said meetings. The said Deputy Comptrollers shall report to the Comptroller all violations of law and shall give him such other information as he may from time to time call for. Except as herein provided the Comptroller shall continue to exercise all the authority and powers now exercised by him.

Section 22. That any Bank District Association may at any regular or special meeting of the Association, by affirmative vote of a majority of all members of such Association, cause the organization of its members into Bank Subdistrict Associations, fixing the number of Subdistrict Associations and assigning each of its members to one of said Subdistrict Associations. Such Subdistrict Associations shall be so formed that the members of each Subdistrict Association shall be located in contiguous territory, and all banks in any one city or town shall be assigned to the same Subdistrict Association. Such action by any Bank District Association shall be submitted to the Comptroller of the Currency, who shall transmit the same with his recommendation in regard thereto to the Secretary of the Treasury, and upon approval of such action by the Secretary of the Treasury, the same shall become effective. Bank Subdistrict Associations shall be organized and administered in the same manner as Bank District Associations, and all the provisions of this Act relating to Bank District Associations shall in every respect apply to Bank Subdistrict Associations, except that certificates of guaranty issued by any Bank Subdistrict Association shall be used only as security for certificates of guaranty to be issued by its Bank District Association. Each Bank District Association shall, at its annual meeting, fix what proportion of the monthly charge, if any, shall be paid by the Subdistrict Associations to such District Associations for the issue by it of its certificates of guaranty.

Section 23. That all Acts or part of Acts inconsistent with the provisions of this Act are hereby repealed.

Note

A separate Act would have to be passed for the appropriation of funds for the acquisition of the shares of the Central Bank by the government of the United States of America.

DECEMBER 30, 1908

V

A CENTRAL BANK SYSTEM AND THE UNITED STATES OF AMERICA

IN dealing with the problem of a "Central Bank of the United States," one should properly discuss first the advantages and disadvantages of the central bank system in general, and then the particular problem of a central bank of the United States.

For the purpose of this discussion, however, I may take it as a matter of common agreement, that in the present state of our civilization, wherever circumstances permit of its establishment, the central bank system is the most suitable and efficient. When the millennium comes, when the reign of eternal peace is ushered in, and when competing armies and navies no longer exist, we may see a system which will centralize all the gold of all countries into one big international reserve, or a system which can be operated without the use of any gold at all, as some theorists, like Professor Knapp, of Strassburg, foresee. I, for one, do not believe that either we or our great-grandchildren shall have to discuss these possibilities as more than theoretical questions.

While we all hope that the arbitration movement will continue to grow and that wars may in the future become less and less frequent, the possibility of struggles among nations always remains. Hence nations will never consent entirely to abolish their armies and navies, and just as little as they will give up their reserves of powder and guns, will they agree to give up their reserves of gold. This is important; for while, within the confines of our own political boundaries, our present money system acts as a national clearing house—crediting to each of us the net result of his work, and accomplishing this practically without the actual use of gold, by means of bank accounts or of checks to bearer, viz., bank notes,—still ulterior payments between nations, whenever all other means of settling a debit balance with a creditor nation have been exhausted, must be made in gold.

To meet the immense volume of demand obligations, which are, by their terms, payable in gold, there exists in actual gold under a modern banking system an amount equal to but a small fraction of the total amount of gold debts. This system is therefore safe only if the credit of the banks is so strong as to inspire a confident reliance that even if actual gold in large quantity is at one and the same time demanded from one or from several banks, the metal will not be needlessly and wastefully hoarded, the public and the banks themselves being confident that money so withdrawn will be redeposited, so long as there remain some institutions the credit of which cannot be shaken. Furthermore, the system must be so constituted that in case of a demand for gold each solvent bank will pay out the metal freely and boldly, recognizing this as the sole method of stopping an internal drain, and of preventing it from degenerating into a panic. In addition, the system must provide for a means of successfully combating the export of gold, and of encouraging its import, when necessary, through the medium of the discount rate. This again presupposes the existence of a large volume of safe commercial paper endorsed by, or bearing the acceptance of, well-established banks or bankers, paper which is salable at any time and which, by the customs of the country, is freely purchased or resold by financial firms and institutions, as their daily needs develop. Finally, the laws governing and safeguarding the creation and collection of such paper must be so clear and uniform and the collection of such paper in every part of the country must be so easy, as to make an investment in such paper not only the safest, but also the quickest asset of a bank. These conditions actually prevail in countries enjoying a powerful and well-organized central bank.

There is a very old English phrase saying, "John Bull can stand anything, but he cannot stand 2 per cent." Since this phrase originated, centuries ago, John Bull has seen lower rates, but none the less it remains true to-day. It means that money seeks to draw a fair return of interest, and it illustrates, furthermore, why a period of too easy money invariably brings in its train a period of expansion and overspeculation. With both phases the central bank is intimately connected. As the meteorologist draws his chart showing the points of high and low pressure, and from these deduces the probabilities of wind and weather, so a map could be drawn showing how money, among financially well-organized nations, flows with absolute certainty from the point of low-interest rates to the point where a higher return can safely be secured. And just as low pressure is not the only factor determining atmospheric transformations, but as temperature and humidity are important elements as well, so in the movement of money also there are important local questions to be taken into account. Such are the rates of exchange which, as the case may be, either add to the interest rate to be earned in another country, or else decrease the return to be received. There is furthermore the question of the degree of confidence enjoyed by each country.

As the insurance premium is commensurate with the risk of each transaction, so money exacts a larger return from investment in countries which are considered financially less secure or in which, owing to a smaller or more irregular market, the investment cannot be so quickly resold. The total amount which the investor is willing to place in each particular country will depend upon these considerations.

An investigation of European conditions will show that money moves freely, according to this principle, between the larger and well-regulated European financial centers. In the face of political antagonisms money will flow to that center where the highest interest return can be received, provided that confidence in that particular country is so strong that the higher rate does not act as a deterrent but as an inducement. Thus French gold began to flow into England when the English bank rate went up to 7 per cent at the end of last year. French capital at the attractive interest rate was invested in English bills to such a degree that the balance between the two nations turned in favor of England, and had to be settled by shipments of gold. In a similar way hundreds of millions of foreign capital move into Germany when rates become remunerative there, and leave that country again when the difference in rates, the margin, as the banker calls it, disappears.

We cannot too strongly grasp this idea of the power of the bank rate to protect and to attract gold. Without such power the central bank system is useless; for it would collapse when the first drain occurs.

How is it possible, it is often asked, for England to do this enormous business which comes to it as the world's clearing house, with so small an amount of gold? The answer generally given is that it is possible only through England's power to command the gold—thus implying the idea of immense balances due to England, which are called in when needed. While this at certain times may be correct, it does not state the most important cause, namely, England's credit, the great confidence commanded by the English banks and by their paper and the knowledge that that paper can always be resold without any difficulty whatsoever, and that, if required, it can be collected in actual gold. England's credit and her ability to adjust her rates of interest render her system possible and effective. Between the indebtedness of one nation to another and the actual settlement of that debt in gold there lies as a buffer the borrowing power of the banking communities of the respective countries. Nations financially well-organized will find that for a moderate inducement money will flow to them freely for the purchase of securities, or for the purpose of short-time investment. This buffer is strong in England, as it is weak in the United States. We have no modern and readily salable paper which in critical times we can offer to foreign markets, and while the European banks work with fluctuations within fractions of 1 per cent, our primitive methods often mean that before the tide can be turned we must suffer fluctuations of interest rates of 100 per cent and a fall in the value of securities to bankruptcy prices.

Just as important as the protective power of the central bank is its preventive power. When money becomes too abundant there is always danger that it may leave the country, and also that speculation may be unduly stimulated. It is during such a period of general exuberance and expansion that the central bank, if wisely managed, will draw in its funds and prepare for the coming storm; to accomplish this it will seek to stiffen money rates, and, by sounding its note of warning, it will often avert the coming crisis or modify it into that normal form of natural reaction which inevitably follows any period of great prosperity and expansion.

On the other hand, a perfect central bank system will protect the country not only from too easy money, but also from too high rates during those periods when money is in active demand, as for instance, in our country, during the crop season. During such times a perfect central bank system will, without unduly increasing the rate, provide freely for legitimate demands. It will be prepared to let its reserve decrease materially, knowing by experience that the notes issued in excess of its normal circulation will quickly return after the particular business of a given season has been done. Thus we see that the end of December annually brings with it a large increase in the note circulation of the German Reichsbank, which notes, however, quickly return for redemption during the first two weeks in January.

From the banker's point of view, the chief features and advantages of a central bank system are the following:

1. The protection and replenishment of the country's gold holdings.

2. The creation of an elastic currency which tends to prevent too low money rates in times of abundance, as well as too high rates in times of money scarcity.

3. The establishment of a broad market for commercial bills. This market at bottom owes its existence and its importance to the central bank's readiness to discount such bills at any time, thus making the commercial bill the best quick asset of a bank.

4. The fact that it acts as a bed-rock foundation for confidence in times of stress, because it centralizes the reserves of the country, thus rendering possible their free and effective use.

5. The fact that it creates a central institution able to deal with other nations, in case exceptional measures become advisable, and with which other nations, even in times of the worst panic, can negotiate to furnish or obtain large loans of gold, as has frequently been the case between France and England.

The shortest and most striking way to illustrate the shortcomings of our system will probably be to review our experience of last year. We had, like Europe, gone through a period of rapid expansion, probably over-expansion, and a natural reaction was bound to come to us, as to Europe, and it did come to both. Expansion was probably more acute in Germany than with us. Why then did Germany, much weaker than we, weather the storm without a panic, while we went into a most disgraceful state of utter helplessness and temporary bankruptcy?

We may leave aside the ephemeral question as to which "straw" it was that "broke the camel's back." After a long period of prosperity, there will almost always develop some point of weakness where the break will first occur, and, as a rule, that break and the ensuing strain will bring down other parts of the structure affected by dry rot. Some "bubbles" were pricked in Germany also, and some ugly failures occurred there, but they did not create any panic. Distrust did not spread in Germany, because the general system, being what it is, keeps unshaken the belief that against good assets good money will always be available, and so "hoarding" remains an unthinkable phenomenon. Furthermore, there was unimpaired confidence that so long as the Reichsbank was in general touch with the situation, though some things might be rotten, they would remain the exceptions, and that it would be impossible for all or even any large proportion of the financial institutions to be unsound.

We shall not deal with the question whether with us bad judgment and mismanagement had been so extreme that the resultant outbreak of distrust was, as a natural consequence, bound to be as violent as it proved to be, or whether artificial fanning of the flame by agitation, sensation, and exaggeration played any part in the unfortunate development, or whether such a complete collapse of credit would under any circumstances have been possible had the legal foundation on which the whole industrial and financial structure rested been firmly and equitably constructed and had it been less subject to violent upheavals.

Whatever causes may have combined in the United States to bring about the crisis of 1907, it cannot be doubted that it would never have reached such appalling dimensions had it not been for the lack of elasticity in our currency, the utter uselessness of our reserve, our inability to apply the brakes while we were going too fast, the absence of any means to negotiate for measures of relief with other countries through a channel recognized by them as official, and finally the lack of modern American bills of exchange, which, while serving as the means of settling the daily balances of the nation, would have been assets on which the banks might have realized in Europe and in the United States, by rediscounting among themselves or at a central bank.

When the panic came, no outflow of gold had taken place, and no natural shortage of currency prevailed. Our existing per capita currency was very large, much in excess of that of most other nations, and there were hundreds of millions of currency in the banks and trust companies. But when, owing to an epidemic of distrust, people began to withdraw cash, it became strikingly apparent that our system was only a fair weather system, liable to absolute collapse in adverse times.

Where, as with us, there are no means of issuing additional currency against the best commercial assets, where the enormous reserves of cash, accumulated in the banks, cannot be used because each manager fears a run on his own bank if his reserves go below the 25 per cent limit, it is inevitable that each bank must attempt to draw upon the reserves of every other bank, and that each will hesitate to pay out cash at a time when the panic-stricken public should be fortified in its confidence that its money is safe and that cash is coming out freely everywhere. Under such conditions the drain by the public must increase instead of being stayed, and it is inevitable that the worst and most aggressive hoarder will come to be the bank or trust company, which, realizing that its 25 per cent cash reserve is quite useless, will, as an act of self-protection, and because no other way exists, use every means of "building up" a reserve, by preying on its neighbors, at the very moment when reserves should by all means be decreased.

From such a system there can result only one consequence: a tremendous rise in interest rates and a tremendous fall in the price of securities; and if even these brutal effects do not attract foreign capital and do not convert the home depositor and hoarder into investors, a general suspension—politely called clearing-house certificates—must follow in order to prevent wholesale individual suspensions. Our system, in fact, did not permit us even to suspend scientifically. When New York began to issue clearing-house certificates and all the rest of the country had, as a natural consequence, to follow, the struggle for gold and currency became even more acute among the various cities, and a shameful gold premium which lasted for several months drained Europe's gold chests and brought needless harm and anxiety to our friends on the other side of the Atlantic.

Some years ago a stranger arrived late at night in a German town, and when he was about to leave the station, he saw that there was only one cab left. He hailed the driver, who, however, refused to move, and the policeman explained that as the law prescribed that one cab should always be in waiting at the station the cab could really not be allowed to leave! Ridiculous as this story may appear, it is quite applicable to our law which prescribes that the 25 per cent reserve must always be kept intact.

It cannot be too strongly emphasized that our most urgent needs in addition to the creation of an elastic currency are concentration of reserves and the possibility of concerted action in lieu of our present system of decentralization.

Let us now consider what circumstances there are to prevent us from establishing a central bank similar to those found in the European systems. The chief difficulties are the existence of our bond-secured currency, the decentralization of our note-issuing power and of our reserves, the lack of modern commercial paper on which to base an elastic currency, the existence of our obsolete usury laws, and finally the deep-rooted prejudice against anything bearing the name of a central bank, the fear alike of politics in business and of business in politics.

It is unnecessary to make a long argument against bond-secured currency. Only weak nations or a people in times of stress, generally during a war, have issued bond-secured currency, and every healthy nation as soon as it was again strong enough, has always abolished this obnoxious system of inflation. As long as we have this bond-secured currency, we cannot succeed in getting an elastic one. Bond-secured currency always expands, it hardly ever contracts. Our recent legislation, enacted last summer, was wisely created as a temporary measure only, since a far-reaching reform could not be successfully achieved in a hurry and without thorough research. The new law is an important step in advance, inasmuch as for the first time commercial paper is admitted as a basis for the issue of notes. But unfortunately the issue of notes against commercial paper is made dependent upon the previous issue of bond-secured currency to the extent of no less than 40 per cent of the note-issuing power of a bank. This, and other conditions imposed upon such note issue, make the new currency an emergency currency, but not a healthy and normally elastic currency.

With elasticity we generally connect the idea of the rubber band. If we take an old and frayed rubber band, which has been stretched to its utmost capacity by holding together a large bundle of papers, we cannot make the old rubber elastic by tieing to it a new piece of elastic band. Where this has been done we have indeed made room for more papers and when this new room is filled, some little elasticity will develop, but if the papers should then decrease below their previous maximum size, the rubber band will stay as it is—it will not contract. In order to have effective elasticity, the band must still fit tight when the bundle has been reduced to its smallest size. This means that in order to make the old band elastic we must shorten it considerably before we affix the new elastic addition. In other words, we must first of all redeem our bond-secured currency so that our note issue may hereafter be able to contract in times of abundance and so that roughly from the lowest point upwards the note issue shall remain in healthy touch with the demand for currency.

In redeeming the bond-secured currency, two points will have to be borne in mind: the one is that it must be done without injuring the banks that now own these bonds, or it will never be done—and besides, to do it otherwise would be unfair; and the other is that we must be able to provide new currency when we withdraw the old, so that no scarcity will be artificially created.

If I were asked to suggest how this could be done, I should propose an inverse conversion of the bonds, i. e., I should advocate the conversion of the present government bonds into bonds bearing a rate of interest higher by so much that after the privilege of issuing notes against them shall have been withdrawn, the bonds will sell just as high as, and possibly a little higher, than they now sell with this privilege. This can be done gradually and in various ways; it would indeed mean an increase in the yearly interest charge to be borne by the United States, but it would put our bonds on a natural basis, like the English consols or French *rentes*, so that the American people could afford to own their own government bonds. In fact, this money, by securing a healthy financial system, and by protecting us from a repetition of past convulsions, would come back to us a thousandfold, and would constitute the best expenditure that our government could make.

In creating the new currency, we could probably follow the lines of the recent legislation, and provide for the organization of currency associations throughout the country. These associations, which should be open also for state banks and possibly also for trust companies, and which should be modified in many other respects, would discount the legitimate commercial paper handed in by their members and pass it on with their endorsement to the central issue department at Washington, which in turn would issue its notes against such guaranteed paper. Of course, such paper with such guarantee should be taken at par, and not at 75 per cent, as at present provided, and it should be taken at a uniform rate, to be published from time to time by the Central Issue Department. The currency associations would receive from the institution handing in the paper a certain remuneration for every endorsement or guarantee executed by them. (Whether the profit, after paying for the running expenses and after having accumulated a large reserve fund, should in years to come be paid out to the members of the associations, in proportion to their pro rata of the guarantee, is a detail to be worked out later.) A most important consequence of such a development would be that we should break with our present dangerous system by which the banks are filled with single-name paper which they cannot resell, and which, under our present conception of banking, they could not attempt to sell without ruining their credit. The laws would, of course, have to be so amended that banks could endorse and accept freely as in Europe, and it will in time follow as a natural development that discount companies will be created, as in England, and that when money is in active demand in the South and offered freely in the East, the southern banks, instead of rediscounting with their association, will be able to rediscount frankly and openly in New York or in Boston or in Europe. If, as it is to be hoped, the currency associations and the discount companies will, at the proper moment, begin to establish two different rates for guaranteeing paper, a higher one for single-name paper, and a lower one for paper bearing in addition to the commercial signature the acceptance of a bank or banking firm, we shall give an added stimulus to the modernization of our paper. When our banks once feel that they can rely on being able to rediscount their legitimate paper, they will be able to purchase it freely without, as now, running the risk of dangerously locking up their capital through such investment.

I have repeatedly dealt with this question and with the disastrous effects of our usury laws, and have tried to show that our system is in this respect directly opposed to the European system, and that our almost annual convulsions will perforce continue unless we make our commercial paper the quickest asset and the basis of our banking, instead of using the stock-exchange call loan for this purpose.

As for the organization of such a Central Issue Department, I have also dealt with this question on previous occasions,[1] and I must not go fully into the details of that problem here. Suffice it to say that the board of trustees or directors should be composed of delegates from the various currency associations, of the Secretary of the Treasury, the Comptroller of the Currency, some members of the Senate and of the House, to whom some members of the commercial classes might be added by election of the stockholders. This body of men should elect two governors, salaried officers of highest standing and training, who would be retained in office as long as they are effective and honest, irrespective of the political party that may be at the helm for the time being.

The powers of the Central Department of Issue should be strictly limited, and should be as follows:

To discount paper, running not to exceed three months, for the various currency associations; to make advances against certain bonds (government bonds, savings-bank bonds, etc.) at uniform published rates and up to certain percentages of their market value to be designated from time to time. (Whether such advances are to be made only through the currency association or also direct, is a detail which can be left open for the time being.)

To buy and sell foreign bills running not to exceed three months and bearing at least three *bona fide* signatures.

To deal in bullion and to contract for loans of bullion.

To act as the depository of the Treasury's money without giving collateral.

And finally, to receive deposits from the currency associations.

The Central Issue Department may issue notes which must be covered by gold or commercial paper; no less than one-

[1] Cf. *Defects and Needs of Our Banking System*, and *American and European Banking Methods and Bank Legislation Compared*, supra, pp. 9 and 39.

third of the notes issued to be at all times covered by gold or legal tender.

A Central Department of Issue so constituted would be beyond any possibility of abuse for political or other purposes. The constitution of the board and the limitations of its power preclude any such possibility, however remote.

As the Central Department of Issue must command the highest possible confidence and as it is necessary to provide a strong gold purchasing power from the start, it is suggested that the department be endowed with a large stock capital of, let us say, $100,000,000. In order, however, to prevent any possibility of having the department administered with a view of earning large dividends for the stockholders, it is proposed to limit the dividends to a certain percentage, and after having accumulated certain reserves, to turn over the balance to the United States Government. Whether or not, in consideration of such profit to be received, the United States should guarantee the notes, may be left for future consideration.

The bugbear that somebody might buy the control of such an institution may safely be dismissed. A man or a group of men purchasing all the stock would not derive the slightest profit from it, except the limited return on the investment. They could not appoint the board, and even if they could do so, they would not profit by it, as the department is restricted to a limited number of safe transactions.

The Central Department of Issue should have the right to ask from time to time that the banks, through the associations, deposit with it a certain proportion of their cash reserves, and the law would have to be amended so as to allow the banks to count as cash their deposits with the Central Department of Issue. The object of such an amendment is obvious, as the gold in the hands of the Central Issue Department can do thrice the amount of good that it can do with the individual bank, which, after the organization of a Central Issue Department, need not fear the withdrawal of cash so long as by rediscounting its sound and legitimate paper it can secure currency.

As for greenbacks and silver certificates, I believe that we could well afford to leave them untouched for the time being and possibly use the surplus to be derived from the profits of the Central Issue Department for the purpose of gradually retiring the greenbacks. With the bond-secured currency redeemed and replaced by an elastic currency, it is conservative to hope that with the large exporting power of this country, we shall be sufficiently equipped to protect our gold, and that the greenbacks and silver certificates will represent no more than the pocket money of our large population. However, this scheme with all its details, as far as they can be outlined in this brief address, does not pretend to be the only solution of the problem; it is a suggestion, subject to many modifications. I have great hesitation in outlining it at all, for while the Monetary Commission is so seriously at work, accumulating material for thought and study, I should have preferred not to express any views at this time. However, as this most important question cannot be solved by the politician alone, nor by men of science alone, nor by the business man alone, I feel that we, each of us, must do our little share, when called upon, and I therefore accepted your invitation, though fully realizing my own shortcomings for such an undertaking.

The advantage of the scheme as outlined is, that instead of trying new experiments, it proceeds on lines which have been successfully followed in the most important financial centers. Conditions are too different with us to permit of an exact copy of any of the European systems; but the proposed plan would tend toward the gradual evolution here of conditions that, as we develop, would render the Central Issue Department more and more efficient and simple in operation.

Some schemes which have heretofore been advanced propose to leave the note-issuing power with the national banks, and to regulate their reserves and rates by a central board or similar institution. I for one, do not believe in such plans. Their shortcoming is, that in order to be efficient they must interfere too much with the liberty of conducting business. For such a central board would eventually have to dictate the rates at which the banks would be allowed to take money or to lend money, and a general guarantee of deposits is only one of the logical consequences of such a scheme. As a matter of fact, under that scheme there would be one central board managing all the banks—an entirely new departure and much more drastic than any central bank. If under that scheme such central interference were made less effective than above outlined, our present defects, viz., the weakness of scattered reserves, and the danger of the decentralization of the note-issuing power among more than 6,500 banks, would remain as obnoxious as before.

Other schemes have been suggested, which propose to regulate the whole question automatically by a tax; but automatic measures cannot possibly meet in the most efficient way all the different eventualities that may arise. A drain from within must be met in a very different way from a drain from without, and a drain from both within and without will again have to be treated in a different way. How, then, can we hope to attempt to create one measure which by a tax will automatically meet all these varying requirements? Besides, these measures provide for inflation without creating new reserves or effective means to attract and retain the gold. Most of these measures will remain passive measures; they have scarcely any preventive or protective power at all.

Some people believe that we should imitate the Canadian system. Without going into the question whether a system that has proved a success for six million people would also be well adapted for a population of eighty-five or ninety millions, (and without discussing the point whether this system, like many others, could survive in the absence of the close relationship with the well-organized English banking community), we shall follow out only this one thought: The Canadian system is based on the small number of some 30 banks with branches in every hamlet. The minimum capital of a bank admissible by law is $500,000, but the majority of the banks have a much larger capital, some up to $14,000,000. Of our 6,650 national banks, 5,367 have a capital of less than $100,-000. Are all of these to go into liquidation? And would not a concentration of the whole banking power into the hands of a few gigantic institutions with branch banks bring about the very conditions which popular sentiment abhors, and which the government is striving to avoid?

The central bank system—and also the modified system of a Central Issue Department—stands for sounder principles in this respect: it centralizes reserves and brings about the possibility of concerted action in the face of danger. By creating safe conditions, it makes the small bank independent and the danger of an overpowering individual control, instead of being aggravated, is for this reason immensely lessened by a Central Issue Department. Thus the Central Issue Department would protect the small bank and not menace it as is generally believed.

The Central Issue Department is sound also in this, that each transaction which it brings about, directly or indirectly, is a plain business transaction. If a bank desires its paper guaranteed by the currency association the bank pays the commensurate commission for such endorsement, and the guarantors earn the commission. If the currency association finds the security insufficient, it will refuse the business. Each transaction is an individual one, carefully scrutinized, and there is no unbusinesslike wholesale guarantee.

Nor is there any real interference; each bank deals with the currency association of its own free volition, and through it with the Central Issue Department. The Central Issue

Department can post the rates at which it is willing to do business with others, but it cannot force anybody to do business at these rates, nor directly interfere with anybody's conduct of business. It is its indirect influence which is strong, and which is of the most beneficial effect.

Furthermore, it is a sound principle that the financial affairs of a nation should be guided not by an automaton but by will-power and brains behind the machinery, though strong restrictions must give the assurance that this will-power cannot go beyond certain safe lines. Such a system will be a vast improvement upon our present Treasury organization, which is constructed, on the one hand, in order not to do what a central bank of issue ought to do and which, on the other hand, as a consequence of our defective system, has gradually vested in the Secretary of the Treasury more autocratic and dictatorial powers than any central bank manager could ever exercise.

Finally, banks are money-making concerns. Money making and money issuing are two entirely distinct functions. It is precisely in order to abate eagerness in making money that the issuing of money at times must be rendered more difficult. Moreover, the note-issuing bank must be put beyond the danger of material losses and beyond the possibility of being drawn into individual transactions, for otherwise its credit will not be unassailable as it absolutely must be, even in times of the worst panic. The ordinary bank, on the other hand, has the duty of taking commercial risks and of carrying on individual transactions. That is why with us, as in every modern country, general banking and the issuing of notes must be kept separate.

I have avoided calling the institution of the future a central bank, because, as proposed here, it is not a central bank. If, instead of the independent currency association, this Central Issue Department were endowed with active branch offices dependent upon the head office, such a name would be correct. No doubt, a central bank with active branch offices would be the more efficient, so far as concerns the controlling of the country's gold, its money rates, and its financial safety. But with our present political and financial conditions, it would probably be impossible, and in many respects unsafe, to vest such vast powers and duties in one body. Though the system suggested by me may be a little less effective and more cumbersome, we must, for the beginning, at least, interpolate the currency association, or some similar institution, to stand as guarantor and examiner between the Central Issue Department on the one side and the local bank and its customer on the other. As our banking paper becomes modern, and as safe standards for the same develop, as we outgrow those financial and political dangers which are stronger in a country in its period of rapid growth than under conditions of more advanced and slower development, we may gradually —and it is to be hoped, soon—simplify the system. But it is safe to leave this further development to the future, provided that we now find the right principle for the establishment of a sound basis. In constructing such a basis, it is better to err on the conservative side than to attempt too big a stride at the beginning. While we may disagree as to the extent to which a central bank system may be applied in the beginning, there cannot be the slightest doubt that the principle of that system must be adopted.

It is most surprising that so ineffective and obsolete a currency system as that of the United States should have been so long maintained by so eminently practical a nation. The explanation is that the wonderful resources of the country, its marvelous prosperity, and natural everlasting credit balance against other nations appeared to legitimize and justify our system. The currency reformer has always been met with the argument that while theories might be good for poor little

Europe, practice proved that the American system was sound enough for the United States. We had to live through last year's horrible crisis to learn that we had been prospering in spite of our system, not in consequence of it, and that, unless we effect a thorough reform, the future is bound to bring us similar disasters and similar disgrace as the past.

It is our duty to keep the memory of the crisis of 1907 fresh in our minds, for unless we grasp not only the danger but the certainty of its reappearance, we shall not realize the blessings and the absolute necessity of a central bank system in the United States.

MARCH 23, 1910

VI

A UNITED RESERVE BANK OF THE UNITED STATES

THE summary of a recent investigation undertaken by the *Banking Law Journal* discloses the fact that out of 5,613 answers given by national and state bankers to the question: "Do you favor a central bank if not controlled by 'Wall Street' or any monopolistic interest?" 59⅓ per cent were affirmative, 7 per cent were undecided, and 33⅔ per cent were negative. Almost all the negative answers, as far as published, are based upon the argument that a central bank, if established, could not permanently be kept out of political or "Wall Street" control. Between the opponents and the champions of a central bank plan there is complete unanimity of opinion that such a system should be tried in our country only if the dangers of "Wall Street" or political control can be absolutely averted.

The main question at issue is this: Is it possible to evolve a plan which, while containing these elements of safety, will at the same time be completely practicable?

It is our belief that no progress can be made by meeting the sweeping assertions of those opposed to a central bank plan by equally sweeping replies, but that advance is possible only by outlining a tangible plan for such a bank. This, on the one hand, will give to those not yet familiar with the actual working of such an institution an opportunity for study, and on the other hand it will force the critics of such a plan, it is hoped, to offer specific and well-defined objections which may lead to some definite results.

It should be stated at the outset that the plan here submitted does not suggest a central bank such as exists in various

European countries. It is a scheme based upon conditions peculiar to our country and our form of government. It recognizes the vast territorial area of the United States, the diversity and dissimilarity of interests, and even the traditional, sectional, and partisan prejudices of the people. In consequence of this, many features which are contained in European plans and which figured, to some extent, in the operations of the First and Second Banks of the United States have been omitted, while certain features foreign to European organizations have been incorporated. All the underlying principles of safe and intelligent modern banking, however,—principles which must be adopted if we are to obtain a banking system adequate to our present and prospective needs—have been observed and are embraced in the plan. This essay, while advocating the central bank idea, submits a much modified system, which we should like to designate as the "United Reserve Bank of the United States." The plan does not pretend to be final or complete in all its details; its purpose is to indicate the fundamental principles upon which the solution of the problem depends and to point out one method of solution.

The strongest arguments made against the plan of a central bank in the United States are those advocated by Mr. Victor Morawetz and by Professor O. M. W. Sprague. We have made free to answer these two critics in the second and third parts of this essay, and, in endeavoring to refute their arguments, have attempted at the same time to meet the principal objections of other critics whose writings have come to our notice.

I

Let us assume that a United Reserve Bank of the United States be established in Washington with a capital of $100,-000,000 fully paid. Let us assume the United States divided into twenty zones of operation, similar to the currency-association districts now proposed by the Aldrich-Vreeland measure, each zone of operation to contain a voluntary association of banks grouped around a financial and commercial center, in accordance with a plan to be worked out in detail. To form the operating associations, which we shall call banking associations, the banks within each zone should have the privilege of appointing from their own number a board of directors, who in turn may appoint a president or managing director of the association. Certain mistakes which crept into the Aldrich-Vreeland Bill must be avoided. The measure should be drafted so as to permit a bank to withdraw from the association at will; to restrict the obligations of each bank to certain transactions, in each case carefully examined and approved by the associations; and also to enable the associations, with the approval of the Secretary of the Treasury, to group themselves into subdivisions. One might simplify the formation of these associations by making them stock companies, each bank within a zone of operations having the privilege of subscribing its *pro rata* share, according to its capital and surplus.

In order that the board of directors of the United Reserve Bank in Washington may be thoroughly representative of the various interests and districts of the country, that it may be non-political, non-partisan, and non-sectional, a certain number of the directors, say three-fifths, should be appointed by the banking associations; a further number, perhaps one-fifth, should be elected by the stockholders; while the Secretary of the Treasury, the Comptroller of the Currency, the Treasurer of the United States, and others to be nominated by them, should fill out the remainder of the board. It might be advisable to provide that no director, excepting the *ex officio* members, should serve more than a certain number of years in succession.

In order that commercial interests be adequately represented, provision might be made that the members appointed by the stockholders should not be bank or trust company presidents, and that these members should be elected preferably from the class of merchants and manufacturers. One would then have a mixed board, of which three-fifths would be bankers, appointed by the banking associations, while one-fifth would be chosen from the commercial classes by vote of the stockholders, and one-fifth would be *ex officio* government members and the additional members appointed by them.

This board should have the right to elect one or two governors of the United Reserve Bank, who would be salaried officers appointed, like other bank presidents, for an indefinite time, irrespective of political considerations, and remaining in office as long as they render satisfactory service.

The share capital of the United Reserve Bank could be divided among the banks of the country under a fair plan of apportionment, or the stock could be sold to the public. The dividends on the stock should be limited to, let us say, 4 per cent. Any profit in excess of this should go to the government. A provision that no one stockholder be allowed to have more than a certain number of votes should be inserted.

The United Reserve Bank should be authorized to perform the following functions:

1. To accept deposits from the government of the United States and from members of the banking associations only. No interest should be paid on such deposits, but they might be counted as cash by the banks and trust companies making them.

2. To buy from members of the banking associations, at a discount rate to be published from time to time, commercial paper having not more than twenty-eight days to run, and issued at least thirty days before the date of rediscounting. The aggregate amount which it might buy from each member should be restricted to a certain proportion of the unimpaired capital and surplus of such member, and the aggregate amount issued by one issuer of commercial paper to a member of the banking association and rediscounted with the United Reserve Bank, should also be limited to a certain proportion of such unimpaired capital and surplus.

3. To buy from member banks, at a discount rate to be published from time to time, commercial paper having more than twenty-eight days to run, but in any case less than ninety days. The aggregate amount to be rediscounted by the United Reserve Bank from each member and the aggregate amount admissible from individual makers of notes should be restricted as under (2). Such paper, however, could be discounted by the United Reserve Bank only with the endorsement or guarantee of the banking association to which the member belonged.[1]

4. To buy, at a discount rate to be published from time to time, paper having not more than ninety days to run, drawn by a commercial firm on, and accepted by a bank, trust company, or banker, and endorsed by a bank, trust company, or banker. One of these signatures should be that of a member of the banking association. Limits as to amounts of acceptances admissible from time to time for discount with the United Reserve Bank should be fixed by the central board.[2]

5. To buy bills on England, France, Germany (and such other countries as may be decided upon), such bills to have a maximum maturity of ninety days, to bear one commercial signature, to be drawn on and accepted by a well-known foreign banking house and endorsed by a member of a banking association or a banker in good standing. The United Reserve Bank should have power to resell all bills that it might buy and to do all things necessary for their collection.

6. To deal in bullion, and to contract for advances of bul-

[1] In consideration of such guarantee or endorsement, the banking association would receive from the member handing in paper for rediscount a certain remuneration, let us say ¼ or ½ of 1 per cent in the interest rate. The banking associations would, of course, like the clearing houses when clearing-house certificates are issued, have the right to reject any paper which they did not deem safe or proper to guarantee or endorse.

[2] It might be advisable to provide that in case of emergency the central board, with the approval of the Secretary of the Treasury and the President of the United States, might increase the limits fixed under (2), (3), and (4).

lion, giving security therefor, and paying interest on such advances.

7. To buy and sell bonds and Treasury notes of the United States.

8. To issue circulating notes, payable on demand in gold; such notes to be secured by bills, bought by the bank under provisions (2) to (5), and by gold to the amount of at least 33⅓ per cent of the aggregate amount of outstanding notes.

9. To establish branches in places where there are head offices of banking associations. Such branches under the direction of the central board of the United Reserve Bank, might do the same business as the head office. Each branch would have a local board, chosen by the board of managers of the local banking association, to which board might be added some members of the commercial classes appointed by the head office in Washington. This local board would supervise the business of the branch bank, and elect its salaried president, subject to the approval of the central board in Washington.

10. To request banks or trust companies desirous of making use of the services of the United Reserve Bank, to keep with its branches a cash balance commensurate with the amount of business done by them. The United Reserve Bank should have the right to transfer sums of money from the account of one member to that of another upon request.

11. To join the clearing-house association of the various cities where the bank and its branches are located.

Let us now consider the plan, as above outlined, from the following points of view: First, would it be safe? Second, would it be effective? Third, would the vested interests of the banks have reason to oppose or favor it, and can the general prejudice existing against any such plan be overcome?

The chief criticism that has been raised against a central bank is that it is subject to the danger of control either by politics or by Wall Street finance. Would this danger exist under our plan? Could anybody acquire control? Nobody could do so if a provision were made that the stock should be divided among the 18,000 banks of the United States.[1] But even without such provision there would be no danger on this score. A man or a group of men acquiring the whole capital stock of the United Reserve Bank would, after all, acquire the right to appoint only a few members of the board, who would be in a hopeless minority against the combined members of the banking associations of the whole country and those representing the government.

But furthermore it is evident, with the restrictions placed upon the United Reserve Bank as to the transactions in which it might engage, and with the restrictions as to the earning power of the stock, that the control of the United Reserve Bank by one individual or a group would not offer any attraction.

As an investment it would not pay, because any earnings in excess of 4 per cent would go to the government, and as for securing help for speculative ventures or aggrandizement of power, this aim could not be achieved by the control of a bank restricted in its dealings to the purchase of short paper from member banks, and of three-months paper which could be acquired only from the banking associations. Taking into consideration all these safeguards, namely, the method of appointing the board, the restriction of income on the stock, and the limitation of transactions permitted, it is absolutely safe to say that under such a system any fear of undue financial or political control may be dismissed once for all.

Secondly, would the plan be effective? It is easy to devise a plan that would be ultra-safe, and not very hard to create one that would be effective, but to combine safety and effectiveness is difficult. Let us first determine what is the main

[1] The author is fully aware that there are only about 6,500 national banks now, but it is to be expected that under any new plan all national banks would become state banks or all state banks national banks. It would, however, lead too far to go into this question here.

object of a central bank, and then investigate whether the plan above outlined would fulfill this purpose.

A central bank acts as a central reserve of a nation. Its first duty is to see that a proper proportion is maintained between actual cash reserve and all demand obligations of the nation which are payable in cash at the option of the payee, but of which the majority are habitually paid by exchange of credits. Its duty in this respect is two-fold: on the one hand, to protect and to strengthen the country's holdings of gold, and on the other hand, to establish and maintain a perfect system of credit, enabling the general banks to transform cash credits into actual cash with such absolute ease and certainty that the use of the cash credit, instead of the actual cash, will not cease, no matter what may happen. In other words, there must not remain the faintest possibility of hoarding during a crisis, or the system will fail. In order to assure this, cash credit must not only be as good as cash, it must be better than cash! The carrying of cash entails a risk of actual loss as well as a loss of interest; a cash credit is free from this first-named evil and, in addition, investments which can be quickly turned into cash credits bear interest. The general tendency of civilized people in a well-organized country must therefore be to free themselves as rapidly as possible from cash and to transform it into the safer and more economical cash credit or into assets which can be quickly transformed into cash credits. Every idle token of money must, therefore, under a modern system return without delay into the central reservoir, where it must be unreservedly available for every legitimate demand for cash. There must never arise any doubt that a legitimate demand for cash will be met promptly and that legitimate quick assets can be turned into cash credits.

If quick assets can be promptly and reliably turned into cash credits, and if cash credits can be turned into cash at will, then it is certain that all such credits never will be turned into cash at the same time, because nobody has any use for so much cash and therefore he will not ask for it, as long as he is sure that he can get it.[1] This is the only basis on which our modern system of immense demand gold obligations, built up on a comparatively small amount of cash, is safe.

Let us use an illustration for this fundamental point:[2]

If after a prolonged drought a thunderstorm threatens, what would be the consequence if the wise mayor of an Oriental town should attempt to meet the danger of fire by distributing the available water, one pailful to each house owner? When the lightning strikes, the unfortunate householder will in vain fight the fire with his one pailful of water, while the other citizens will all frantically hold on to their own little supply, their only defense in the face of danger. The fire will spread and resistance will be impossible. If, however, instead of uselessly dividing the water, it had remained concentrated in one reservoir with an adequate system of pipes to direct it where it was wanted for effective use, the town would have been safe.

Ridiculous as these conditions may appear, the parallel with our own financial organization is evident. Our reserves of cash are entirely disconnected; they are insufficient for even a single institution in times of serious stress, and instead of being a protection they are a dangerous weakness, because the consciousness of insufficient protection causes one bank to try to draw on the reserves of others, and the very moment these mutual attacks begin, panic inevitably follows.

Our true conditions are, as a matter of fact, even more preposterous than those in the Oriental town, by reason of our law prescribing that a certain proportion of the deposits must be kept in cash,—a law which must be observed if a bank wants to preserve its credit. Not only is the water uselessly

[1] This applies only to the internal drain. We shall deal later with the demand for gold that might arise from without.

[2] This illustration is taken from the writer's pamphlet, *The Discount System in Europe*, published by the National Monetary Commission, which appears on p. 183, *infra*.

distributed into 18,000 pails, but we are permitted to use the water only in small quantities in proportion as the house burns down. If the structure consists of four floors, we are practically forced to keep one-fourth of the contents of our pail for each floor. We must not try to extinguish the fire by using the water freely in the beginning; that would not be fair to the other floors. Let the fire spread and give each part of the house, as it burns, its equal and insufficient proportion of water.

As long as the owners of houses threatened with fire know that the central water supply is well in hand, with one central power, available wherever danger may arise, everybody feels safe and is not frightened by the thought that if all the houses should burn at the same time there would not be enough water to go around. Though there may not be enough water for the last house that might burn down, even the owner of that last house would not ask that some water be kept back for him, because he realizes that unless the fire be stopped before it reaches him, his own little supply of water will not help him.

If, however, a central system does not exist, everybody will hoard water, trying to steal it from his neighbor or from the community by tapping some source in order to create a supply of his own. He will lessen thereby the full supply that ought to be led into the central reservoir, without protecting himself adequately in time of danger.

The main function and object of a central bank is to make every dollar which lies idle return to the central money reservoir to make it available to the fullest extent, wherever and whenever it can do good legitimately, and to provide a system of mains, by which it can be conveyed quickly to any point of danger.

Note issue is not a fundamental, but only a side question, and it is very important to grasp this fully. If the British government should issue a government loan and use the proceeds to pay into the Bank of England in gold £18,400,000, thereby paying off its present indebtedness to the bank and providing a gold cover for the uncovered portion of the note issue of the bank, the latter could pay off every one of its sterling notes in gold. If this were done, the only change would be a change in pocketbooks, to enable people to carry gold instead of notes. The central bank system of England would go on absolutely undisturbed. With or without the note-issuing power, the Bank of England would remain the central reservoir of gold. It would continue to protect England's gold holdings and to maintain the proper proportion between the country's demand obligations and actual cash. It would continue to guarantee the prompt transformation of cash credit into cash and of quick assets into cash credits.

This is possible only through the discount system. The banks know that they can, in case of need, rediscount their legitimate bills with the central bank. The central bank, on the other hand, having a large investment in bills of short maturity, can, by increasing its discount rate, withdraw from new investments and thereby strengthen its reserve. Incidentally, by increasing the interest rate of the country, it attracts foreign money, wards off gold exports, and by throwing part of the burden on the general banks brings about a general contraction of business.

Money flows where it can draw good interest in safety. Where credit is firmly established and financial organization sound, money flows easily from one city or country to another, for a difference in interest of a fraction of one per cent. It is humiliating to realize how large a margin in interest rates we must offer to attract money, as compared with our European competitors. This question and the working of the discount system, of which the central bank system is a part, have been dealt with fully in my previous paper, so that I need not dwell on them here.

Elastic note issue, that is, the power of a central bank to issue notes not fully covered by bullion, is an auxiliary measure. The central bank system becomes safer and more pliable by this addition because, the lines being less rigid, the fear of reaching the end of the tether is not so great; and, furthermore, since the result to be reached is not exclusively dependent upon the discount rate, the latter need not be changed so often and so drastically as with an inelastic system.

To return to our metaphor: note issue represents an auxiliary reservoir. Where it does not exist, the men in charge of the central reservoir have to advance the price for water so as to discourage extravagant use whenever the available supply falls below a safe margin. Unsecured note issues enable the managers to use this auxiliary supply, which renders it possible often to provide for the needs without increasing the price for the water, where the increased demand is normal and only temporary.

To decide when to supply water freely, when to warn the consumer to save, and when to limit the supply without ever refusing to comply with legitimate demands, is the duty of the central bank. No automaton—no tax or fixed regulation—can perform it, but the best judgment of the best experts must indicate the policy to be pursued from time to time. In addition, it must be the exclusive care and responsibility of one institution, chartered and constructed for the single purpose of maintaining the proper proportion between demand and supply.

With us the general banks, which are the consumers and represent the consumers, are at the same time the regulators. Where everybody regulates himself, there is anarchy and chaos in times of stress. Money making and the maintenance of a safe proportion between cash and cash obligations are at times distinctly opposed functions, and the performance of these functions should lie in entirely separated bodies. The general banks must remain money-making concerns, administered with the full responsibility of being able to meet all possible cash demands by available cash credit. To guarantee that every cash credit can be met, if desired, by actual cash payment, and to avoid the possibility of such general demand for cash —this is the function of the central bank.

Let us consider whether these aims of a central bank can be safely and effectively reached under the system above outlined. The great difficulty in the United States is the complete lack of modern bills of exchange, freely endorsed by the banks and passed on from hand to hand, as in Europe. With us there still prevails the old single-name promissory note, which, under our present system, is practically unsalable once it has entered the bank, and which therefore immobilizes our bank holdings.

To permit the banks to rediscount these promissory notes with a central bank would be the easiest way, but the criticism may be justly raised, that in doing so we should open the door to abuse. Hence the inclusion, in a scheme previously outlined by me, of the banking associations, which, having to guarantee the paper before it enters the United Reserve Bank, would carefully examine and sift it. The interjection of the banking association would make the paper safe beyond peradventure and, if nothing else could be found or agreed upon, this system might well be adopted for the present.

The criticism, however, has been raised against this method, that it would be fairly clumsy and that in normal times the banks would try to do without it. Therefore it would remain only an emergency system, out of touch with the market in normal times. To meet this difficulty, it is proposed in this plan to empower the United Reserve Bank to take directly from members, without the guarantee of the banking associations, bills with not more than twenty-eight days to run.

This thought developed from the following observation: Upon examining the report of the Reichsbank one finds that on December 31, 1908, it held in German bills M. 1,032,000,000; of which 44 per cent were payable within 15 days, 17.4 per cent within 16 to 30 days, 24.8 per cent within 31 to 60 days, and 13.8 per cent within 61 to 90 days. This brings out the surprising fact that the maturity of 61.4 per cent of all the bills held by the German Reichsbank was of 1 to 30 days. The average duration of all bills held by the Reichsbank is thirty-four days. A similar proportion could be shown by the Banque de France, where the average duration of all bills held is even less, namely, twenty-four days.

How is this to be explained? It means that if, when making up its daily balance sheet, a German or French bank finds that on balance it needs money, it will send to the Reichsbank or Banque de France for discount its bills falling due the next following days. These central banks have a complete schedule for each city where they have an office, stating the minimum number of days that will be deducted at the bank rate, without any further charge for collecting the bill. To illustrate this procedure: the Reichsbank in Berlin will charge on a bill beyond M. 5,000 a minimum of four days for bills on Berlin, a minimum of five days on Hamburg, Bremen, Frankfort, and similar cities, a minimum of ten days for smaller bills on small and remote towns. This means that when the rate for call money and the bank rate are about even, a Berlin banker will send his bills on Hamburg to the Reichsbank for collection five days before the bills mature; if he collected them through his own correspondent in Hamburg, he would lose one day's interest at least, which would be consumed by the return trip of the money after the bill had been collected; and the longer the distance, the larger the loss of interest. When money is very easy, it pays the banks to lose that day's interest, and collect the bill themselves, since, instead of submitting to a discount of five days at 4 per cent, they might pay on call six days at 2 per cent or 3 per cent and still fare better. This illustrates how, by keeping its rate higher than the ruling interest rates, the central bank withdraws its funds from general business and accumulates reserves for times when stronger demands arise. The stronger this demand grows, the longer will be the bills which are being sent for discount to the bank, until they reach the permissible maximum of ninety days.

A consideration of these facts brought up the question whether it would not be feasible and conservative to allow such institutions as may be admitted to dealings with the United Reserve Bank to rediscount with it directly, and without the intervention of the banking association, legitimate paper having no more than twenty-eight days to run. It would appear that this could safely be permitted. A bill which has only a few weeks to run embodies a much smaller risk than one having three months to run. General conditions and the standing of the bank offering the paper for discount, and of the maker of the note, can be judged with a fair degree of safety for a few weeks ahead. The United Reserve Bank would make it a rule not to buy thirty-day notes issued for the obvious purpose of being immediately rediscounted and renewed at maturity, but to acquire only paper originally issued as two, three, or four months' paper, in accordance with the usages of the trades in question. The bank examiners would be trained to ascertain infractions of the rule and, besides, the United Reserve Bank would notice them immediately when the new bill was offered for discount so promptly after the expiration of the old note. The shorter the maturities of bills, the stronger would be the United Reserve Bank's position.

While this plan would be of immense advantage to the banks inasmuch as it would enable them without difficulty to turn into cash at once about one-third of the bills which they have discounted, at the same time it would not encourage reckless banking or speculation. No customer and no bank will dare to enter into extended commitments on the strength of an advance of twenty-eight days. What will happen after this lapse of time one does not know, and he must be prepared for possible retrenchment by the United Reserve Bank.

Moreover, some rule would have to be established that the aggregate amount of such short bills sent in for discount by any bank should not exceed a certain percentage of its capital and surplus, and that the aggregate amount of paper sent in for discount issued by one individual or concern should not exceed a certain part of such surplus and capital. This method would appear to be entirely safe; if deemed necessary, the twenty-eight-day limit might be reduced to twenty-one days. In the writer's opinion a twenty-eight-day limit is conservative.

We should then have one rate at which the branches of the United Reserve Bank in the banking association cities would take short bills directly from members, and one rate, possibly the same, at which they would take longer bills from members with the guarantee of the banking association.

There remains to be established one more rate, the private discount rate, at which the United Reserve Bank would take sixty- or ninety-day bills, drawn by commercial firms on, and accepted by, a bank, trust company, or private banker as under (4) . The private discount rate of the United Reserve Bank would be kept very low in the beginning, for the purpose of encouraging shippers at home and abroad to use the credit of American banks, where now they use foreign credit. Shipments of coffee from Brazil to New York and of cotton from Galveston to Boston are now usually financed by long drafts on Europe. Under this plan such banking transactions will be turned over to the United States. Bills will be drawn on American banks and bankers, instead of on London, Paris, or Berlin, and instead of being financed by others we may gradually become the "financers" of others. Not only will this increase our trade, but most important of all, once we establish the modern banking bill in the United States, its use will grow and our banks will reap the tremendous advantage of being able to invest their deposit money in assets upon which they can quickly realize at home and abroad. As the use of this modern paper increases, so will the financial safety of the banks and the business community.

These bills will be strictly commercial in character and it will be an easy matter to scrutinize the legitimacy of their origin. At least two well-known banks, trust companies, discount companies, or bankers must accept or endorse them, and one of these names should be that of a member of a banking association. This is much more than any European central bank requires, and it should be entirely sufficient to provide against any political or financial danger in this respect. On the other hand, the powers given are far-reaching enough to bring about the most important change, viz., the creation of modern American bills of exchange.

There remains to be considered one more field of activity for the United Reserve Bank; that is, its privilege of buying foreign bills having not more than ninety days to run. This power is necessary for obvious reasons. It would afford the United Reserve Bank an opportunity to employ its idle funds in times when the management should decide upon a policy of withdrawing funds from use in the United States, and it would enable the bank to accumulate an interest-bearing gold reserve; for foreign bills are available for the purpose of drawing gold from foreign countries, and they also serve as a means for warding off withdrawals of gold.

We now have a fair outline of the normal functions of the United Reserve Bank. Though restricted in its dealings to the utmost limit of safety with respect to its scope of transactions and to its circle of clients, its effect will be most far-reaching.

The cash reserves now scattered and useless will be concentrated into an effective central reserve. The general banks will hold a sufficient amount of till money for their requirements, but as a reserve they must hold a cash balance with the United Reserve Bank, commensurate as at present with the aggregate amount of their deposits. If cash is withdrawn from the general banks, they in turn will draw on the United Reserve Bank for their needs and will replenish their balance by sending to it for discount short or long bills. As a result the dreaded cash withdrawal will lose its terrors for the banks.

If a Chicago bank withdraws its balance from a New York bank, all the latter has to do is to notify the United Reserve Bank's branch in New York, by a transfer check, to transfer the amount in question from the account of the New York bank to that of the Chicago bank. Wherever branches of the United Reserve Bank are established, the wasteful remittances of cash between members will cease. The bank will act like a huge clearing house for the settlement of balances between various sections. Millions are now constantly in transit, moving to and fro, crossing and recrossing one another in opposite directions. Hundreds of millions are kept in scattered balances, which can be centralized under the new system.

While banks now immobilize their assets by buying commercial paper which is legitimately issued, but which is practically non-negotiable, and while they use for quick assets call loans on the stock exchange, that cannot be called in a panic or a time of stringency which falls short of panic, the new system makes commercial paper a quick asset which can be converted into a cash credit or into actual cash. Our present scandalous system of attempting to regulate the money market of the entire country by first pouring money into the stock market and then withdrawing it, creating inflation and exorbitant security prices, followed in due course by stringency and unnecessary price depression, will give place to more orderly movements, as our discount markets develop.

This plan would be incomplete if it did not touch upon, without discussing in detail, the question of the government bonds and the notes issued against them by the national banks. It is certain that this question must be dealt with in a way entirely fair to the national banks. Otherwise they will oppose the plan. Having bought these bonds under the note-issuing privilege, they are entitled to due consideration if this privilege is to be withdrawn. It is most opportune that, whether we want a central bank or not, our miserable system of bond-secured note issue has at last come to a fatal *impasse.* One of the most beneficent influences of the construction of the Panama Canal is that it is opening our eyes to the impossibility of linking together the aggregate amount of the funded debt of a great nation and the aggregate amount of currency in the pockets of the people. There is no doubt that this foolish inflation of our currency and of the price of our government securities must now stop. There is furthermore no doubt that elasticity means expansion *and contraction* and not expansion alone, as results from our present currency system.

In order to secure an elastic currency and a safe basis for a United Reserve Bank, we must reduce our outstanding currency somewhere, so as to substitute the new elastic note issue —an issue that will contract, so that it can expand with safety. One way would be an inverse conversion; that is, a gradual withdrawal of the existing note-issuing power with a simultaneous conversion of our government bonds into obligations bearing a somewhat higher rate of interest, thereby safeguarding the banks against a loss in the price of their bonds. This would bring the price of our bonds to a normal level, like those of England, France, and Germany, whose people can afford to hold government securities. The higher interest rate to be paid by the government to the people would be the most wisely spent money in our entire budget. There are several other ways of dealing with this problem. Suffice it to say here, that to solve this part of the problem does not offer insurmountable difficulties. It will be necessary only to investigate which method is the best and offers the least resistance.

II

Let us now turn our attention to the criticisms of those opposed to a central bank system in the United States.

Mr. Morawetz says[1] that the territorial expanse of the United States is too large for such a system, that the bank would be one of too "colossal magnitude" and that it would be necessary to place the central bank in a position to regulate and control financial conditions throughout the country. He furthermore claims that the central bank would either "have the power to discriminate," and therefore "the managers would be placed in the attitude of beneficent dispensers of bank credit and of prosperity" or, if properly restricted, the bank would be "a penny-in-the-slot machine for obtaining credit," the resources of which might be drawn upon too heavily by "banks engaged in speculative business or located in sections of the country where interest rates are high."

The size of the country is an argument not against, but for, a central bank system. A small and unimportant country could live with a less perfect system, and could lean upon the other central bank countries in times of need. The immensity of our country, our resources, and our transactions render it absolutely necessary for us to adopt the most efficient system in existence.[2] The greater the area, the more perfect the system must be in order to reach every remote point. The plan here outlined covers the whole country. Each section of the United States, as a matter of fact, will have a central reserve bank of its own, where directly—or indirectly through its correspondents—each bank in the United States will enjoy the advantages offered by the United Reserve Bank. While the general policy will be settled at the head office, in consultation with the presidents of the branch offices and the members of the central board, the actual business will be done by the

[1] Victor Morawetz, *The Banking and Currency Problem in the United States*, The North American Review Publishing Co., N. Y., 1909; and *Address on the Banking and Currency Problem and the Central Bank Plan,* delivered at the Finance Forum of the West Side Y. M. C. A., Nov. 24, 1909.

[2] Our weight has become too heavy and threatens at times to break the European machinery which we use to make up for the lack of elasticity in our own system.

branch offices, which will act as separate units for each section.[1] There will be this most important difference, however, that, as far as reserves are concerned, they will be united and act as one. The surplus of one section will be available for other sections and the interests of all together will bring about the general policy of the United Reserve Bank. The effectiveness of this plan would not be interfered with by a provision that the discount rates of all the branches need not necessarily be the same. Thus it might be possible to meet undue expansion in one section of the country by increasing the rate of that branch without increasing the rate for other sections.

As outlined here, the United Reserve Bank will not be a "penny-in-the-slot machine," any more than the European central banks, which discount and advance upon uniform conditions published from time to time. The United Reserve Bank would certainly have the right to refuse any paper that did not appear safe or legitimate. Furthermore, the power to increase or decrease its rate and its circulation would place it in a position amply to protect itself and the country. At the same time, the restrictions placed upon it absolutely preclude any danger of its becoming "a beneficent dispenser of bank credit and prosperity." The fear that some section, where interest rates are high, might absorb all the available means of the United Reserve Bank, may be dismissed from consideration. The proportion to be fixed between capital and surplus and the amount admissible for rediscount with the United Reserve Bank would prevent such abuse. Besides, as this facility of rediscount is a most valuable element in the strength of a bank and its real reserve, no conservatively managed institution would go to its full limit in normal times. An institution known to abuse its rediscounting privilege would quickly lose standing in the community.

Mr. Morawetz's next criticism is directed against the "con-

[1] Even the banks at Washington, D. C., would deal with the United Reserve Bank only through a local branch office, like all the other banks in the country.

trol of the bank." It is contended that there would be too much of one-man control, or control by a group; that the bank might become involved in political strife or become the issue between contending political parties. The first two points we have already answered at length, and little remains to be added in this respect. The central office would merely indicate the policy; the branches, which practically are under the supervision of the local banking associations, would undertake certain well-defined, safe transactions, into which no element of politics could enter, any more than it enters into our clearing houses. No political patronage whatsoever would be connected with the United Reserve Bank. A conscientious and honest man, not even brilliant, would be required to fill the presidency, at the pleasure of a board which, as we have seen, would be made up of the best men the various banking communities could secure as delegates. There is no reason, despite our critics, why such a board should not work harmoniously and effectively, and whoever examines the plan from an unbiased point of view will see no danger of excessive power being vested in one man.

Mr. Morawetz claims that great disaster would follow if the central reserve bank, once established, should be abolished again. Quite true; but should we hesitate to build a water reservoir, because we feel that it would be a calamity if one day it were to be removed? It is safe to say that if a system were established as safe as the one here outlined, it would develop as our country develops. Its requirements might change; but just as little as we can go back to the old mail coach after the railroad, just so little can we return to our present impossible system, once we have modernized it. If frauds or patronage fill the post office or the custom house or the Army and Navy or the Treasury, we should clean up but not abolish those departments. Though it is difficult to perceive how under our plan abuse could develop, in such a case we should clean the house, but we should not destroy it. Mr.

Morawetz concludes his argument by saying that a central bank should not be tried because if it should fail, the cause of true reform would be postponed for a generation. In so doing, he reminds me of a man who should refuse to be born, for fear that he might die!

Now let us analyze Mr. Morawetz's plan.[1] Under it, Mr. Morawetz provides for a board of managers, to be elected by the banks. This board, in conjunction with the Secretary of

[1] [At the request of the editor, Mr. Warburg left this section as written in the spring of 1910, though Mr. Morawetz later modified his plan in some particulars.—Ed.] Mr. Morawetz's plan provides for so-called "note-issue associations," embracing practically all the national banks of the country. The banks will appoint a board of managers, who in conjunction with the Secretary of the Treasury will have authority to establish branches wherever they deem it advisable, the main office of the association being at Washington.

The main function of the central office and the branches will be to regulate the issue and redemption of notes. Each national bank will be entitled to issue against its general assets an amount of notes equal to its capital stock. The board of managers, however, has the right to increase the amount of note issues of the banks to some fixed percentage of the capital stock of the banks, and this board also has the power to reduce such increase as it may have authorized. Each bank having taken out notes will be required to keep on deposit with the association, as redemption fund for their payment, a sum of lawful money equal to such percentage of the notes as may be prescribed from time to time by the board of managers and the Secretary of the Treasury. The required percentage of the redemption fund will be fixed from time to time by general order applying equally to all the banks, but the required percentage will never be less than 20 per cent of the outstanding notes. It is left open for further discussion in the plan whether each bank shall receive a special note issue and shall keep a separate redemption account, or whether it will be practicable to have one joint issue and one joint redemption account.

The general idea of the plan is that when notes are issued, they shall be covered by a substantial amount of cash to be set aside in the redemption fund, let us say 40 to 70 per cent. The board of managers will have the power, in times of stress, to allow a reduction of this reserve in the redemption fund, which, however, may not be lower than 20 per cent and in times of easy money, the central board may decree that this redemption fund be increased up to 100 per cent, so as to withdraw the notes, finally, from circulation.

The plan provides for the withdrawal of all national bank notes secured by government bonds. Some provision has been made to protect the bonds owned by the banks.

the Treasury, will have the right and duty of dictating to every bank in the United States what percentage of cash it must hold against its outstanding notes.

We grant that such a board could be so constituted as to be safe; but every argument raised by Mr. Morawetz against the dangers of political or one-man control of the central bank board, can be applied with equal force to his board of managers. However, the power of this board of managers is more far-reaching and of broader scope and therefore more dangerous than that of the board of the United Reserve Bank. While the central bank is a passive institution, Mr. Morawetz's board of managers is an active institution. The central bank establishes rates at which it is willing to do business, but it does not force anybody to do business with it. If the bank rate should be 5 per cent, banks in the South may find it to their advantage during the cotton crop movement to rediscount with the United Reserve Bank, while banks in New England may for the time being dispense entirely with its services, and therefore not be affected. If, however, the board of managers, under the Morawetz plan, issues its command that all banks must increase their reserve against notes from 30 per cent to 40 per cent, it is a direct interference with the business of every individual bank in the country, no matter if money is easy in Boston and tight in New Orleans. Expansion and contraction is ordered, whether it is needed or not, for every one at the same time. How about "expanse of territory" in this case? Is it possible to regulate all the varying demands of the varying sections of our immense country at the same time by one "You must!"? It is Mr. Morawetz's "You must!" against the United Reserve Bank's "You may!" This difference is most important.

Furthermore, while the United Reserve Bank is enabled to perform its functions by the freest return of idle money into the central reservoir, thus avoiding its being needlessly held in separate reservoirs, Mr. Morawetz would force every one at the same time to withdraw more cash and to lock it up as special collateral for new notes. This power to influence money rates, vested in a few men, would, from Mr. Morawetz's own point of view, form a grave danger.

Leaving aside this phase of the question, the system is unsound for these further reasons:

1. Our examination of modern systems has shown that note issue is only a side question. It is a poor plan, therefore, to try to solve the main problem by attacking an auxiliary part of it. It is just as unsatisfactory as the attempt to repair a broken-down dynamo by readjusting the storage battery attached to it only as an auxiliary emergency device.

2. Notes issued by banks must be considered as demand deposits, since for both payment in cash may be demanded. It is an unfair and unscientific plan to secure one depositor by 50 per cent or 60 per cent of cash, while the other must be satisfied with 20 per cent.

3. It is a faulty system that will change practically the whole outstanding currency carried in the pockets of the people into money which the banks may not hold when it is paid in to them.

4. It is an anomalous and unsound system that allows a bank to pay its creditors in notes which it may not carry as reserve, or that forbids it to carry as reserve against a deposit notes the very receipt of which may have created such deposit.

5. The Morawetz plan tries to solve the problem exclusively by issuing more or less currency. But it is cash credit, not currency, which is required most frequently. The two are not identical.

6. A bank is safe in granting time loans against time money which it may have taken; the excessive granting of time loans (loans and discounts) against call loans (deposits) is dangerous and often the cause of financial disturbances. A bank already overextended, makes its condition more dangerous by granting further accommodation through note issue. For in-

creased note issue means an increase of demand obligations, while rediscounting of paper with a United Reserve Bank means an outright sale of assets. That is, cash credit or cash becomes available without the creation of a new and dangerous demand obligation.

7. The vicious system of separated, disconnected, and competing reserves remains unchanged.

This is only an outline of the main arguments against Mr. Morawetz's plan. It would lead too far to follow up in detail every single point.

What would the effect of this system be? There were in the United States in 1908, according to the report of the Comptroller of the Currency:

	Nat'l Banks	State Banks	Trust Co's	Sav. B'ks
Number	6,853	11,220	852	1,453
Cap. Stock......	$921,000,000	$502,000,000	$278,000,000	$36,000,000
Surplus.........	566,000,000	217,000,000	370,000,000	244,000,000
Cash...........	889,000,000	308,000,000	118,000,000	44,000,000
Deposits........	4,374,000,000	2,937,000,000	1,866,000,000	3,479,000,000

Under the Morawetz plan, the 6,853 national banks, which are money-making concerns, competing against one another, with deposits of $4,374,000,000, would have to bear the burden of regulating not only their own condition, but also that of the other institutions, having deposits of $8,282,000,000. But let us suppose the state banks all turned into national banks. We should then have 18,073 banks, with a capital of $1,423,000,000; surplus $783,000,000; cash $1,197,000,000; deposits $7,311,000,000. In order to bring the state banks up to the standard of the national banks, figuring only a 25 per cent reserve, a cash reserve of $1,462,000,000 would be required, being an addition to bank cash that must be withdrawn from circulation of $265,000,000. Every bank will have the right to take out these notes to at least the amount of its unimpaired capital, and the board of managers may authorize larger issues. Let us take the minimum, $1,423,000,000, and a reserve of only 40 per cent. This would mean an additional withdrawal of cash of $568,000,000, or a total of $833,000,000. This means that two and three-fourths times the amount of cash held at present by all state banks, or about the total aggregate amount of cash now held by all the national banks, would have to be withdrawn from circulation and be replaced by bad notes—bad because they cannot be used by the banks as reserve money. Taking the above figures as a basis, it means that there would be in the hands of the public about $1,400,000,000 of national bank notes, while the circulation of such notes under our present system amounts to about $700,000,000.

When there is a demand for more currency, and not for more credit, the plan may work for a while, though weakening the currency; but when there is currency enough in the pockets of the people, while demand for additional credit continues, every note issued will return at once through the redemption fund and must be paid in cash. Every bank will then try to accumulate legal-tender notes, to strengthen its power of granting credits, and will therefore at once present for redemption the national bank notes that it receives.

Crises have frequently arisen because people believed that the top wave of demand for accommodation had passed, and all means had been spent in this expectation, when the main pressure had not yet begun. If during such critical times gold withdrawals from abroad should begin, it is difficult to see how under this plan reserves could be strengthened, for it is to be expected that in such a case the reserves would already be at the lowest point. Then we should again witness the critical times when one bank, by refusing to renew its call loans and thus throwing the burden on the others, creates a credit balance for itself in the clearing house, thus strengthening its cash balance at the expense of the others. Retaliation would follow, and panic would be in sight in the future just as it has been in the past. The weakness of our present system in this respect would remain unchanged.

This plan would leave the Treasury money either wastefully piled up and withdrawn from circulation, or it would leave to the Secretary of the Treasury arbitrary power to dispense favors by depositing the funds wherever he may prefer. It would leave promissory notes as immovable in the future as in the past, with no hope of ever developing a modern system of bills of exchange. I have no hesitation in saying that it would be a most reckless experiment, on entirely new and untried lines, and it would in my opinion lead to certain disaster.

Mr. Morawetz's plan contains two suggestions: one, as we have seen, being the regulation of reserves against note issue, and the other being the creation of sectional reserve banks. It is greatly to be regretted that Mr. Morawetz has emphasized the first scheme and touched only slightly upon the second. It is sincerely to be hoped that he will work out in detail this plan for sectional reserve banks, which he desires to be at all times in a position to furnish reserve money to the several banks in their sections by paying checks drawn against the deposit accounts of the banks or by rediscounting paper offered by them for that purpose.

I am confident that Mr. Morawetz will soon reach the conclusion that these sectional reserve banks must be endowed with all the powers and charged with all the duties given under our plan to the United Reserve Bank branches; otherwise they will be nothing but safe-deposit vaults, which will have to hold for each bank the exact amount of cash received from it for safe keeping. They cannot go a single step further without incurring the gravest danger unless they have some central bank to fall back upon, or unless they are themselves central banks, that is to say, disconnected central bank branches. Mr. Morawetz tries to cover the weakness of decentralized reserves by providing that the several sectional reserve banks be authorized to make arrangements with one another in order to facilitate exchanges between different sections of the country. But there must be more than this authority to make arrangements with one another with a view to facilitating these exchanges. These sectional reserve banks must in the end act as a unit. Otherwise we shall have a recurrence of our experiences at the end of 1907, when one reserve center closed itself against the others, when enforced credit was established *within* each financial center, indeed, but when New York, Chicago, Philadelphia, Boston, Pittsburgh, and all the others, would not accept even the joint obligation of all the banks of their sister cities. Obligations between cities remained payable in cash, and distrust among these centers brought about the actual phase of the gold premium and the long period of general suspension of cash payments. Should a common foe attack Boston and New York, would Illinois keep her soldiers at home, or would she differentiate between Boston and New York? The knowledge that all will stand together gives a feeling of confidence and safety. It is the same with our financial reserves: they must be held united under one direction, to be thrown where they are needed and to be withdrawn from places where they are superfluous. The joint credit of the nation must stand behind the reserves, insuring unlimited confidence that nothing will be able to shake.

There must be one big reserve, one note-issuing power, one big bank, which will be neutral, administering impartially and economically the funds of the Treasury of the United States, and issuing notes that are good enough not alone for the people, but also for the banks to be counted as cash. Instead of 20,000 institutions carrying an average of 8 per cent cash against their deposits and notes, what we need is one big institution with a capital of $100,000,000, acting as reserve for all and maintaining a normal reserve for its notes and deposits alike of probably 80 per cent instead of 8 per cent. By following the central bank plan and adapting it to our conditions, we know with certainty that we are following along lines which have been thoroughly tested elsewhere and have led to success everywhere. Therefore, even with equal advantages otherwise, the central bank plan should prevail.

In fairness to Mr. Morawetz it ought to be stated that he has never denied the superiority of the central bank system. In fact, he advocates its adoption wherever it can be done with safety, but he believes that our peculiar conditions render it impossible to evolve a plan which will be at once safe and effective. Fear of a dangerous centralization of power has led him to prefer an attempt to control a scattered note-issuing power and has induced him to advocate separate sectional reserve banks rather than an actual unification of reserves.

The object of this essay has been to show that these half-measures will not afford adequate relief and that they invite, and even to a larger degree, the very dangers which are supposed to be inherent in the central bank plan. On the other hand, this essay has been designed to prove that it is possible to evolve, on the sound principle of a central bank, a plan which will not only be effective but at the same time meet the difficulties which Mr. Morawetz has so forcibly pointed out. Through his criticism he has helped us gradually to perfect the present scheme, and now that we have perhaps succeeded in meeting his objections, we trust that he will continue to help, not only by criticism, but by coöperation in further developing the scheme on lines which he himself has recognized as at least ideally the best.

III

Professor Sprague has published an article entitled "The Proposal for a Central Bank in the United States: A Critical View."[1] The conclusions which the author reaches in this essay are as follows:

> A central bank does not appear to be either required or well suited to relieve our financial difficulties. On account of the

[1] *Quarterly Journal of Economics*, vol. xxiii, May, 1909.

absence of branch banking it would not be able to handle the government funds in a satisfactory fashion, or to provide an elastic note issue. *Branch banking is an essential preliminary, if we are to have a Central Bank of anything like the European type*, and there are powerful objections to such a change, the discussion of which does not fall within the scope of this essay.

Neither from the historic nor from the practical point of view is this conclusion correct. Effective central bank systems existed in Europe before the branch-banking system was evolved. The Bank of England was organized in 1694, the Banque de France in 1800, the Bank of the Netherlands in 1814, and the Bank of Austria-Hungary in 1815. In all these countries the central banks performed their duties effectively during a period when banking concentration in the modern sense had not begun and when private banking firms were still transacting the main banking business. The phenomenal growth of the joint-stock banks, the absorption of private firms, and the all-embracing development of the present branch-banking system are an evolution which has taken place in Europe almost entirely within the last thirty years, and which reached its present predominating importance only within the last twenty years. The evolution of branch banking is not incidental to a central bank system, nor is the central bank system the outgrowth of branch banking. Branch banking, in its present form, is incidental to the unlimited power of expansion and concentration which followed the evolution of the modern stock company, the corporation.

From the practical viewpoint it is a mistake to think that branch banking is a preliminary step essential to a central bank system. The influence of the central bank is stronger with a system of small and disconnected banks than with enormous branch-banking organizations which, singly or combined, are so powerful that at times they are able to pursue a policy of their own in contravention of that of the central bank. While it is true that when these banks coöperate with the central bank, the latter may accomplish more immediate results, the fact remains that these larger institutions are able, at times, to emancipate themselves entirely from the influence of the central bank and that when in the end they are forced by circumstances to fall back upon the reserves of the central institution, the sudden weight is such that the central bank finds it difficult to carry the burden.

Enormous banking concentration has been watched by the managers of central banks with a feeling of concern rather than with a friendly attitude. The central banks look upon the independent and smaller institutions as their most loyal followers, and the central banks stand, as a matter of fact, as protectors of the smaller institutions against the aggression and the overpowering influence of the larger ones. However, the jealousy between the large banks and the central banks, sometimes prevailing in Europe, need not exist with us, since in Europe the central banks compete, to a certain degree, with the general banks; a situation which would be avoided by us under the present plan. One might dissolve to-day all European branch-bank organizations into the many independent banks and banking firms which originally constituted these big concerns, and the central bank system would not suffer in efficiency from such a change. One might eliminate all the branches of the central bank, and the central bank system would still remain efficient though it would achieve its results in a somewhat slower, less direct and hence less economical manner. On the other hand, the elimination of the central bank system in England, France, or Germany would force the smaller independent banks to surrender at once to the big banks. Without the protection of the central bank they could not survive.

The basis of the central bank is the centralization of reserves and what Professor Sprague calls "the fluidity of credit." Eliminate these two, and the central bank system must fail. Professor Sprague says in respect to this:

> The fluidity of credit is absent in this country, and will remain absent while we wisely continue to prefer banks managed by persons with extensive local knowledge to branch banks subject to bureaucratic managers, acting under general rules laid down at a distant head office. For this reason we cannot expect our money markets to be subject to the comparatively slight and distant influence exerted by a central bank. It would be necessary to concentrate bank reserves to such an extent that every banker would feel that his safety depended upon the situation of the central bank.

To begin with the last sentence of Professor Sprague's observations, it has been shown in the previous chapters of this essay that the absolute concentration of banking reserves into one central reservoir is the very foundation on which a modern structure should rest, and there can be no doubt that every banker in the United States would be satisfied as to the absolute safety of reserves under such a system of centralized reserves, for which, as a matter of fact, the credit of the entire United States would be pledged.

Professor Sprague's suggestion that fluidity of credit is based upon branch banks cannot be admitted. What does fluidity of credit mean? The very expression points to a credit that is liquid; it means the very thing to which I have so often and so insistently drawn attention, the question of rendering liquid the assets of a bank. Whether we had branch banks or not in the United States, the present system of issuing and handling American bills, which form non-liquid assets in the hands of the banks, would stand in the way of fluidity of credit. A central bank in the United States, even with a fully developed branch-banking system, cannot effectively perform its duties unless we find some way of making these immovable promissory notes movable instruments of credit. The object of this essay is to show how a central reserve bank system, as here proposed, could fill the present need in this respect, and pave the way for further development in the right direction.

Professor Sprague's main arguments are based upon the mistaken idea that a central bank in our country would need thousands of branches in order to *deposit* equably all over the country its own and the government's moneys and in order to *distribute* impartially its notes among the banks.

To quote his argument in this particular:

> The manner of putting this vast sum (being the balances of the United States Government) into general use would be equally without precedent. Without doubt there would be a general demand that the deposits be used with a general degree of approximation to population and the supposed needs of different parts of the country. At this point an insurmountable obstacle would be encountered. To lend directly to the business community would require an impossible number of branches. Lending at the relatively small number of branches which we have assumed might be established would not accomplish the purpose.
>
> In order to distribute its funds widely, the central bank would be obliged to lend to at least as many banks as there are localities; and, since the selection of a single bank would give rise to charges of favoritism, the bank would be certain to lend to all the banks. The central bank would be obliged to decide between the claims of 15,000 or more banks.

This shows an entirely erroneous conception of the activities of a central bank in general and of our United Reserve Bank in particular. Under our plan, the central institution would neither deposit moneys nor distribute notes; it would discount paper and collect discounted bills as they fall due. Depositing moneys is an operation in which the initiative would rest with the central bank and in which the danger of favoritism might be lurking. For the operation of discounting bills at a published rate, the initiative rests with the general banks and, within certain limits, with all banks alike. The United Reserve Bank does not reach the banks, but the banks reach the United Reserve Bank; and the organization as here proposed would enable each bank in the country, directly or indirectly, to reach the central institution.

While as a matter of safety, economy, and efficiency a number of branches as proposed in our plan would certainly be advisable and feasible, there is no need for thousands of branches to reach every single point where banks are in existence. Professor Sprague evidently does not appreciate the spreading power of the discount rate. When promissory notes or "bills" become "bills of exchange," money for safe and legitimate purposes flows easily from one end of the country to the other, and the higher the development of the discount system, the more the spreading power of money will be felt and the safer our system will become. While our plan does not attempt to provide the highest degree of fluidity for the present, it will create conditions under which the spreading power of the discount rate will be felt at once, and that will insure efficiency for the United Reserve Bank and safety for the country.

We cannot imagine that the prices for staples will ever vary greatly between New York and San Francisco in spite of their territorial separation. The maximum difference would probably be the cost of transportation between the two cities. This is explained by the fact that we have established certain brands or standards as the basis of our dealings, which enable us to purchase and sell by letter or telegram without negotiating for individual bags or boxes which we sample and select. Without this method we should deal with necessities as we deal with luxuries, paying for each article a fancy price, which price may differ widely in the various parts of the country, though the quality be the same. In this respect the bills receivable of an American bank are like a collection of curios, selected with care and pride by the president of each institution, but difficult of sale unless another collector is found who happens to be interested in the same article, and who does not possess too many of the same kind already. Bills receivable in Europe are like so many bales of cotton, bushels of corn, or bags of coffee, standardized, homogeneous articles, which can be sold at once. The discount rate of the central bank, on the strength of which the general discount market develops, is a potent factor in bringing about the creation of standardized bills of exchange. This evolution in the United States also will follow the establishment of a United Reserve Bank, which from the beginning, even with our present conditions, will be able to provide a fluidity of credit sufficient to make the plan effective.

When we conceive clearly the fundamental ideas underlying the working of a central reserve banking system, we see the lack of force in Professor Sprague's argument that "our difficulties would appear, as in the case of government deposits, as soon as the attempt was made to place the notes where they were really needed,—in agricultural sections of the country," since in his opinion the banks generally would be too eager to secure these notes and use them as reserves. Under our plan a balance with the United Reserve Bank is equivalent to cash in hand, and therefore there will be no eagerness to secure notes, except as they may be required for actual circulation.

Professor Sprague appears inclined to think that a further danger inherent in a central bank scheme would lie in the direction of increased expansion. Under existing conditions, in his opinion, the risk of undue expansion could be averted and "normal seasonal variations in credit requirements could be readily met if our banks were less given to the habit of lending to the full extent of their resources in months when the course of business gives them an abundance of cash." His final recommendation is that the six largest New York national banks should hold reserves of 30 per cent in times of financial quiet, and that they should use these reserves freely, without considering the 25 per cent limit, in times of financial disturbance. Incidentally the suggestion is made that reserve city banks and central reserve city banks be not allowed to pay interest on bankers' balances. These suggestions are coupled with a curious panegyric, praising the use of the clearing-house certificate, with a somewhat disguised recommendation of partial suspension of payments as a legitimate means of meeting extraordinary demands, and with an attack on the New York banks on account of the "ignorance of our bankers of the only method which experience in other countries has shown to be uniformly successful in allaying financial panics." The method here referred to by Professor Sprague consists in meeting unreservedly, by freely paying, any demand for cash made upon the banks. In this respect he makes the following statement:

> We already have far more centralization of banking power in New York than is generally realized. Before the crisis of 1907 the six largest New York national banks held net bankers' deposits of $305,000,000 out of a total of $410,000,000 of such deposits held by all the national banks of the city. It is somewhat disconcerting to find that these banks, which held a reserve of $140,000,000 in August, 1907, still held $110,000,000 in December, 1907.

No stronger argument can be made in favor of a central bank than is contained in this statement. Once a panic begins under our present system of decentralized reserves, there is no other means of salvation for reserve and central reserve city banks than to stop payments. In their anxiety the country banks, which held $305,000,000 of balances in New York, would have withdrawn the entire $140,000,000 available in New York in August 1907, and while this process of diminishing reserves in New York was taking place, it stands to reason that the demand for cash within New York by the other depositors of the New York banks would have increased at the same dangerous rate. A system of decentralized reserves without any provision for transforming cash credits readily into cash must inevitably come to grief in a period of distrust, no matter whether the New York banks keep reserves of 30 per cent or 25 per cent in easy times.

Professor Sprague does not appreciate the difficulty these six banks would have in realizing when conditions for legitimately decreasing the reserves actually prevail. These banks are primarily money-making concerns; if, during times of strong demand for accommodation, they should refuse to grant it and call-money rates should rise to extraordinary heights—as they inevitably must under our present system—these Wall Street banks would be accused at once, as they always have been in the past, of greed and manipulation. If they should meet the demands, yielding to such clamors, their reserves would soon diminish, and conditions would remain as heretofore. When the panic came, as come it inevitably would, it is more than probable that the reserves of the banks would already be below 25 per cent.

Furthermore, if we carried out Professor Sprague's suggestion, that the central reserve city banks should not allow interest on deposits to other banks, the immense balances kept by country banks in New York would cease, and the restrictive power which Professor Sprague wants to apply to these banks would thereby become void. These large amounts are kept in New York for the sole purpose of acting as a safe reserve, but they are not sent to New York to act as "on call" assets which at the same time earn interest. It is for this reason that Professor Sprague's remarks are not justified when he says: "The failure to adopt proper methods seems to be due not so much to inability as to a failure to recognize the responsibility of their position by the New York banks which hold bankers' deposits." Country bankers demanding interest on their balances cannot expect to have them kept in cash.

It is strange that a writer searching for remedies on the lines of the above suggestions should find fault with the central bank plan, for the reason that, as he believes,

> It would not be able to exert a restraining influence upon the expansion of credit, because it would have no means of carrying out a precautionary policy. Is it not certain that, in the eager search for funds in times of active business, the other banks would resort to it for heavy loans? Doubtless a considerable measure of accommodation would have been thus granted if we had possessed such a central bank in the years before the crisis of 1907, even though it had been managed with far more conservatism than we have any reason to be certain of securing at certain times. Every dollar thus borrowed would have been an addition to the extension of credit at a time when restraint was needed, not expansion.
>
> The central bank would have been creating a certain amount of credit expansion, which its later power of contraction could certainly not have exceeded, and probably could not have equaled, because the volume of credit cannot be largely diminished without serious disturbances. The power to issue notes by a bank of this kind would be a positive evil unless it were strictly reserved for use only upon occasions of actual emergency.

It is evident that a central bank managed with the single object of watching expansion and contraction, and of maintaining the safe proportion between cash and cash obligations, a bank which cannot be swayed in its policy by any prospect of gain, and a bank the management of which is not subject to the immediate pressure brought to bear by the customer in need of accommodation, will be in a vastly better position to form a clear opinion concerning the large point of view of the country's financial conditions than a local money-making bank. The central bank would not be subject to the same temptations nor to the same attacks, in case it should deem it necessary, in order to force general contraction, to insist on higher discount rates; but, incidentally, its very existence would prevent the exorbitant rates which from time to time are inevitable under our present system.

Professor Sprague's argument that "the central bank would bring about exclusively further expansion of credit," would be sound only if we did not provide for contraction at the same time and from the very beginning. A substitution of notes of the United Reserve Bank for either the bond-secured currency or the greenbacks presupposes from the outset that into our present ever-expanding currency we should inject a large amount of currency which will contract and which must return to the United Reserve Bank the moment that this institution, in easy times, decided to collect its short bills without renewing its investment in them.

No European system provides, as our plan would do—as a logical development of existing conditions—that banks should maintain so substantial a proportion of their deposits as a cash balance with the central bank. This in itself is a regulator; and even if, on the other hand, owing to our present conditions, the United Reserve Bank did not have the same power as that enjoyed by the European central banks, thanks to the importance of the European discount markets, the combination of balances to be kept and transactions to be made with the United Reserve Bank in order to maintain these balances would give it a certain restrictive and regulative power, the possibility of which Professor Sprague denies.

From the practical viewpoint there can be no doubt whatever that the basis for a healthy control by a central bank must exist in a country where regular seasonal requirements cause, with almost absolute regularity, acute increased demands for money and accommodation. A country of this kind will require at given periods certain additional accommodation to avoid stringencies as now experienced by us from time to time, and will stand without disturbance the withdrawal of the additional funds after the seasonal demand has subsided. Because our present currency system is expansive only, and lacks the power of contraction, we experience the difficulty of meeting unusual demands whenever they arise. Why should we assume, on the one hand, that the best men to be found, when placed at the head of such an institution, would be unable to cope with the problem, and at the same time be ready to place the burden on the shoulders of the managers of the six largest Wall Street banks,—the very men whom Professor Sprague accuses of having proved entirely unable to meet the needs of the hour in 1907?

The same argument holds good with respect to the Treasury funds. While denying, on the one hand, the ability of the central bank management to deal with the large funds of the Treasury in the guarded and safe way in which a United Reserve Bank disposes of such funds, Professor Sprague is evidently willing to let the Secretary of the Treasury continue as heretofore to dispense his favors as well as he can.

As to the wisdom of allowing the United Reserve Bank to issue "unsecured notes," the writer believes that under the plan here outlined it is not probable that for many years to come unsecured notes will be issued to any considerable amount, if at all. But it appeared advisable to endow the United Reserve Bank with this privilege, so as to imbue the country with the fullest confidence that cash will always be forthcoming. This confidence will be the very means of rendering unnecessary a large issue of unsecured notes.

It is impossible to reply to every single point enumerated by Professor Sprague. I have therefore singled out these fundamental arguments that needed refutation. But, in closing, let us touch upon one more point raised by Professor Sprague. It is evident that one of the functions of the United Reserve Bank would be to accumulate, in easy times, large amounts of foreign bills of exchange to hold as a gold reserve against emergencies. Professor Sprague believes that this would create anxiety in Europe. An accumulation of foreign bills of exchange would, indeed, give fair warning to the European central government banks that in case of a stringency arising with us they must be prepared to meet a sudden demand from the United States. But the foreign government banks would vastly prefer this danger, which amounts to nothing more or less than the perfectly legitimate collection of debts incurred by their own countries, rather than be subject to the violent attacks to which all Europe is now exposed when a panic is raging with us. There can be no doubt that the unwelcome presentation of a bill payable to the United States, but instrumental in avoiding a panic in the United States, would be much more satisfactory to Europe than a general suspension of payments with all the consequent terrors at home and abroad.

It is a rather amusing coincidence that in this controversy the rôles have apparently been exchanged. One would expect that the professor's and lawyer's point of view would be that nothing can be sound in practice which is unsound in theory, while the banker's attitude might be expected to express itself rather in an attempt at patching up existing conditions by practical measures without much concern about the theory. The banker's view in this case is summed up by asserting unequivocally that no monetary reform will be sound and effective which neglects the theory of centralized reserves and fluidity of credit.[1]

IV

Some critics have raised the objection that a bank as here outlined would not earn its dividends. There cannot be any doubt that the United Reserve Bank will without difficulty earn a return on its capital in excess of 4 per cent per annum. But we should bear in mind that this question of earning power is of very minor importance. If we want a bank which is not to be run for profit, but for the general weal; if we want to cede to the United States any profit in excess of 4 per cent

[1] Just as this essay is going to press, Professor Sprague has begun the publication of a new series of contributions in the *Quarterly Journal of Economics*, vol. xxiv, no. 2. He has here somewhat modified his recommendations, but before dealing with them, it will be necessary to await the appearance of the further chapters which are announced. What has been said of Mr. Morawetz, at the beginning of page 146, however, applies equally to Professor Sprague.

net; and if, at the same time, we want the stockholders to be satisfied with a 4 per cent investment, we should be fully justified in proposing that the United States guarantee a return of 4 per cent to the stockholders. Or, to express it in a happier way, it might be suggested that in consideration of the profits to be turned over to the United States by the United Reserve Bank and in consideration of the savings to be made by the United States in transferring the various disbursing and collecting functions from the Treasury to the United Reserve Bank, the government of the United States should contribute to the running expenses of the United Reserve Bank such lump sum as will enable it to pay to its stockholders a dividend of 4 per cent per annum. It is safe to expect that, once established, the United Reserve Bank will become a permanent source of revenue to the government, and that important savings in its present budget will be effected.

One more word in closing. The thought is general, with people who have not studied the question, that a central bank is a step towards monopoly. The reverse is the truth. Wherever a central bank exists, it is the backbone of the independent institutions in their fight against the overpowering influence of the large stock banks, as they exist in England, France, and Germany. It should be clearly understood that the United Reserve Bank, by creating safe conditions, would make the small banks independent, where they now have to rely, and are dependent for help, on the good will of their big sisters or the often doubtful ability to help of the Secretary of the Treasury. A central reserve bank properly organized is not an oligarchic but a democratic institution; it would mean safety for all, hardship for none.

There is no good reason why the existing banks should oppose it. Wherever a central bank has been established the vested interests at first tried to prevent its creation. They saw only the danger of a change in business conditions which, though bad in general, had been profitable to them. They recognized only later that by the change they were enabled to transact their business in safety and that therefore they could do a much larger business. There is not one of these countries, in which opposition ran high against a central bank, where to-day a move to do away with the central bank system would meet with the slightest support. Neither the socialist nor the capitalist would dispense with it; it has become one of the fundamental parts of the economic life of modern nations, like the telegraph or the railroad.

Would it be repugnant to the so-called American spirit? Is it an un-American institution? Our opinion is that it is a slur and a slander upon the American people to say that they are morally or politically so utterly unfit that they cannot afford to adopt a system for which Russia, Japan, the Balkan States, and some of our South American sister republics have proved adequately prepared and which even China is seriously thinking of establishing in the near future. We believe that the people will wake up to the humiliation of present conditions and that they will demand in no uncertain voice a thorough modernization of our system. We are inclined to think that ignorance about what a central bank would really mean has been more responsible for the popular antagonism to such a system than has the ghost of Andrew Jackson. Good American citizens, who lived two generations nearer than we do to the dissolution of the last Bank of the United States, and were more familiar with its history than are the people of to-day, did not consider it an un-American institution. In this respect Abraham Lincoln's first political speech, which he delivered at New Salem in 1832, may be of interest. He said:

> *Friends and Fellow-Citizens:*
>
> I am plain Abe Lincoln. I have consented to become a candidate for the legislature. My political principles are like the old woman's dance—short and sweet. I believe in a United States Bank; I believe in a protective tariff; I believe

in a system of internal improvements, and I am against human slavery. If on that platform you can give me your suffrages, I shall be much obliged. If not, no harm done, and I remain respectfully yours,

Abe Lincoln.

It is seventy-seven years ago that this simple man from the woods, with his never-failing instinct, laid down this remarkable program, of which only one single part, "a United States Bank," remains to be carried out. Let us hope that it will be the pride of our generation to have achieved this step in the onward march of the United States.

NOVEMBER 12, 1910

VII

PRINCIPLES THAT MUST UNDERLIE MONETARY REFORM IN THE UNITED STATES

PANICS are acute infections of the body economic by the germ distrust. Varying causes may bring about a crisis, which always precedes a panic, but the degeneration of a crisis into a panic is invariably an epidemic of distrust.

Every modern financial system is built on confidence, on credit. Our whole financial structure has become a system of clearings of credit, a system of substituting the token of confidence for the payment in actual cash.

Against the immense amount of demand obligations payable by rights in cash at the option of the payee there is only a comparatively small amount of actual gold. The very moment that a general hesitation sets in to accept this clearing by credit, the very moment that a simultaneous request begins, calling for actual cash in payment of all demand cash obligations, a general collapse becomes inevitable. A modern system must be so constructed that a demand for cash caused by distrust shall be absolutely impossible, or the system is not safe, and the mere knowledge of its being unsafe will precipitate a panic whenever an acute crisis arises.

If a small fire starts in an old-fashioned wooden theater a catastrophe is unavoidable. The mere fact that everybody knows that he is in a fire trap and that the combustion will spread rapidly, brings about a panic with all its horrors of unnecessary loss of life and property. In a modern fireproof building the fire will be quickly extinguished: there will be less food for the flames, there will be a possibility of fighting them, and the feeling of safety will allow everyone to save himself without trampling his neighbor to death or blocking those who also want to escape. It is a critical situation, a crisis, which, thanks to modern construction and wise precaution, does not degenerate into a panic.

Why has our building proved a fire trap and why is Europe's structure safe? Why does Europe's system guarantee the avoidance of panics and why does ours inevitably insure their recurrence from time to time? It is from this point of view that all the material published by the National Monetary Commission ought to be studied and it is from this point of view that the final question of monetary reform must be approached.

Let us then lay down as the first principle which must guide all our further investigations, that no system which is by universal acknowledgment theoretically defective will ever stand the strain of an acute crisis without that crisis degenerating into a panic. It is of no avail to patch up a theoretically wrong system and to strengthen it by some practical measures which give a false assurance of safety. When the storm comes, fear and doubt will begin to creep in through the loophole which logic, then wide awake, will drill, and once well-founded distrust begins, the system loses its basis, which is confidence, and must collapse. Not every measure that is right in theory is good in practice; but what is wrong in theory can never be right in practice.

Let us lay down then the second fundamental principle, that a financial system which scatters and decentralizes reserves, making them unavailable and insufficient in case of need, is fundamentally wrong and defective.

In a modern system, constructed on credit, cash must be centralized as far as possible into one big reservoir, from which everyone legitimately entitled to it may withdraw it at will and into which it must automatically return whenever it is not actually used.

In order to achieve this there must be two guarantees: one, that the central reservoir is safe and strong enough to supply all the cash that may be required from it, so that nobody will hesitate to let it become practically the sole trustee of all cash; and the second, that every bank depositing its cash or allowing it to stream into the central reservoir will be sure to have the means at its command with which to acquire the cash that it may legitimately have to demand.

In order that cash should always return into the central reservoir, cash must become less valuable than the interest-bearing right to command cash, which is embodied in a legitimate bill of exchange. To keep large supplies of explosives under our roof is a source of danger; the safer a community the less is the necessity for us to be provided with ammunition. It is the same with large cash holdings.

Individuals, corporations, and banks alike in a modern household must try to reduce the holdings of cash to a minimum, because cash holding entails the risk of loss and robbery and because a hundred dollars carried in the pocket for a year, or needlessly hoarded, means a loss of four dollars. Instead of accumulating cash, the desire must prevail to dispose of it as quickly as possible and to turn it into cash credits or interest-bearing quick assets.

This leads to a clear division of the functions of the central reservoir and of the general banks. It is the function and duty of the general banks to act as the custodians of the people's money and deposits and to employ the same in conformity with the principle that a bank must not give any other credit than it receives, which means that against all demand deposits it must be able to provide at all times payment by cash credit. It is the function and duty of the central organ: First, to watch that the right proportion be maintained between all demand cash obligations of the country and the actual cash at its disposal; second, to guarantee that every legitimate cash credit can be transformed at will into actual cash; and third, to establish so firm a confidence in its ability to perform these duties that cash will never be withdrawn to be hoarded, but will always return promptly into the central reservoir, leaving in the hands of the banks and the public only the amounts absorbed by actual circulation or taken for gold exports by creditor nations.

From these different functions of the central banks and the general banks, there follow as a logical consequence the different elements necessarily inherent in their reserves. The central bank, having cash obligations, must have the strongest possible reserve of cash and quick assets payable within a short time. The general banks, having obligations payable only in cash credit, need have reserves only in cash credit and in quick assets, convertible at all times into cash credit.

The channel that connects these two systems and enables them both to perform their functions in safety is the central bank's discount rate. The discount rate enables the general banks to build up a cash credit with the central bank, by rediscounting with it legitimate paper, and to draw actual cash against this cash credit, if necessary. It thus renders the maintenance of a large holding of actual cash unnecessary for the banks. An increase in the discount rate enables the central bank, on the other hand, to protect itself by collecting a larger proportion of its maturing bills discounted, decreasing at the same time the amount of new purchases of paper, and incidentally attracting foreign money or warding off gold exports. While cash payments continue without hesitation, the increased rate brings about a general contraction which will result in a safe ratio between the actual cash holdings of the nation and the grand total of its cash obligations.

The less actual cash is required in the process of paying debts and settling balances, the more developed is the system. This applies not only to the transactions within each city, but much more so to the settlements and payments between cities. Whenever a central bank opens a branch in a city, it means that from that day a bank of that community can deposit with that branch a given sum of money, and request that the amount be transferred to the credit of any other bank having an account with the head office, or any other branch of the central bank. This means that a great clearing system will come into existence all over the country, and that cash remittances for account of the general banks will cease to exist between places where there are central bank branches.

We have repeatedly dealt at length with the folly of a system which makes the commercial paper purchased by a bank immovable assets, locking up the capital of the purchaser, and which forces the banks to consider as their only quick assets cash in their vaults which they must not use, and call loans on the stock exchange which during a panic they cannot turn into cash.

We may then stop here for a moment and establish four general principles, as I would like to term them, which follow from our discussion up to this point:

I. Cash reserves must be centralized into one strong organization where they will be available when needed, and where they will command such confidence that they will not be withdrawn except for actual circulation or gold exports.

II. In order to secure the free return of cash into the central reservoir, there must be some means of exchange between the central reservoir and the banks, so that banks may rely on their ability to build up with the central reservoir a credit balance against which they may draw cash if necessary. This medium of exchange must be commercial paper (under safeguards to be discussed later on).

III. Fluidity of credit must be our final aim. A sound financial system must mobilize its commercial paper and make it a quick asset instead of a lock-up. Mobilized commercial paper, instead of bonds and loans on stock-exchange collateral, must finally become the most important basis of our financial structure. The larger reservoir must regulate the smaller one; not *vice versa*, as with us. Discounts in the main liquidate themselves within a comparatively short period, and by the natural process of consumption. Bonds, which are investments of long maturity, are not self-liquidating, but they and stock-exchange loans, which represent undigested securities, must be finally absorbed by the process of investment of the savings of the nation. This is at best a slow process, in which only comparatively few persons participate subsequent to the initial process of general consumption by all. Therefore no nation enjoying a modern financial system bases it primarily on bonds and stock-exchange loans.

IV. Clearings must not stop within the limits of a single city. Remittances of cash at cross purposes between cities are even more wasteful than within a city, for the loss of interest is so much heavier and the danger of cash withdrawals from one city to another is so much greater in critical times. The central reservoir must act as an inter-city clearing house, as it does in Europe.

Here we have the four main general principles, to which, a little later, we shall have to add two more, concerning note issue. These four principles are so self-evident and so absolutely essential that once we recognize them clearly the work to be done by us in reforming our monetary system ceases to be bewildering and complicated. Our compass is set and the only question that remains is whether we can avoid the cliffs that endanger our course. To effect a centralization of reserves and a safe system of inter-city clearing ought not to frighten us as a problem offering insurmountable difficulties.

To the general principles governing every financial system we now add some principles which ought to be observed with reference to our peculiar conditions. These principles I should like to term the local principles. They are as follows:

1. The central reservoir must not be operated for profit. If it takes the form of a bank, as probably it must, the stock dividends must be limited to what would correspond to a fair

investment basis. This moderate return might be guaranteed by the government, which in turn would receive the surplus earnings.

2. The central reservoir would have to be restricted in its operations. It should deal only with banks, bankers, and trust companies. Its main function should be to buy foreign exchange, which it should accumulate in times of ease as a gold reserve, and it should purchase commercial paper from banks and trust companies only.

The difficulty here is that we have as yet no standard discount paper such as exists in England, France, and Germany, and that therefore, in order to avoid abuse, some system must be invented which will act as an effective control and which will supply an additional and safe guarantee. How this can be accomplished I have outlined in detail in an article entitled "A United Reserve Bank of the United States," which was published by the Academy for the Merchants' Association of New York some six months ago and which forms a part of the present volume.[1] It would lead too far to go into details concerning the suggestions made in that essay. They are subject to modifications and were published only for the purpose of showing that it is possible without doubt to devise some scheme which, while strict enough to prevent any abuse, can still be made broad enough to allow of practical and effective operation.

3. The management of the central reservoir must be absolutely free from the dangers of control by politics and by private interests, singly or combined. This can be achieved without doubt by a combination of measures like the following: the stockholders would appoint only a minority of the directors; a small number of additional directors would be furnished *ex officio* by some political officers, but the majority could be appointed by groups of banks all over the country under a system, for instance, like that proposed in the above-

[1] Cf. p. 117, *supra*.

named plan. These directors should elect and appoint the managing governor of the central organ, who would be chosen and engaged like any other bank president, without any political consideration, but with due regard to ability and character alone.

But safety would have to lie not only in this mode of election, but also and mainly in the limitation of the profits and in the restriction of the operations of the central organ. A stock offering a maximum return of 4 per cent combined with the restriction that the central reservoir may not do anything else but buy certain clearly circumscribed paper under the strictest guarantees and injunctions, cannot possibly involve any danger from monopolistic or political domination.

4. The Treasury should cease to deal directly with the banks. The central reservoir should be the recipient of the government's surplus funds and should attend to the government's disbursements. The influence in business of the Treasury, a purely political body, must cease.

5. Cash balances with the central reservoir or its branches must be considered and counted by the banks as cash in their own vaults. The central organ must have power to request the banks to keep with it cash balances proportionate to the amount of their deposits.[1] Thus every bank will be made to contribute to the work of the central reservoir, of maintaining a safe proportion between all cash obligations of the nation and its actual cash, a work which, with the lack of a fully developed discount system, would otherwise remain much less effective. It is fortunate that existing circumstances allow such a measure—which is more far-reaching than similar arrangements in Europe—without adding any new burden to the banks which are in the habit of keeping these large cash reserves. The immense advantage to be gained, without any sacrifice made by the banks, will be that the vast sums of cash accumulated in the central reservoir will be freely forthcom-

[1] "Banks" always means national banks, state banks, and trust companies.

ing when needed, and will insure safety, instead of being helplessly and hopelessly stored away by the individual banks.

6. The central organ must be in a position to contract for temporary loans of gold with other governments or foreign central banks, and to receive or give collateral therefor.

This clause is self-explanatory. The power that this measure would confer would go a long way toward allaying fear, and thereby strengthen and benefit the system, even if the privilege were never made use of.

We have thus far left entirely out of consideration the question of note issue. We have done this because the problem loses so much of its complexity and presents itself so much more clearly if the question of notes, which is only a side issue, is temporarily disregarded; and secondly, it is just because we wanted to show how comparatively unimportant this question of note issue really is, that we have endeavored to present the structure in its fundamental lines complete in itself without embodying note issue from the beginning.

To try to remedy the shortcomings of our present system by reorganizing only the note issue, as many reformers have done, is to attempt to repair a broken-down carriage by hitching to it a fresh horse. Effective centralization of reserves and the creation of fluidity of credit are the main questions. Elastic note issue is a side question, though a very important one.[1]

V. We may now enumerate our fifth general principle, which is this: Inasmuch as note issue, partly secured by gold, is only an auxiliary activity of the central reservoir, the note-issuing power ought to be centralized as far as possible in the central reservoir. For not only does this uncovered note issue give additional safety to the central reservoir, but there is inherent in it a certain regulative power which is lost and

[1] A full argument concerning this point is embodied in the author's article, "*A United Reserve Bank of the United States*," to which reference is made. The writer apologizes for some unavoidable restatements contained in the present essay.

endangered by an excessive decentralized and scattered additional note issue. The point is plain: If notes issued by other banks must be paid by them in cash, these other banks would again become accumulators of cash and thus interfere with the free return of cash into the central reservoir. This would be a fundamental danger. If, on the other hand, they could rely on the central reservoir to redeem their notes in cash, they could work at cross purposes with the central reservoir, antagonize its restrictive policy, weaken its position, and still throw on it the entire burden of final cash redemption.

Bank notes are deposits on demand in bearer form, passing as cash. If we desire to authorize the issue of bank notes partly secured by bills purchased and only partly secured by gold—as there cannot be any doubt we should—the duty to make sure that this proportion remains within safe limits and that the notes are always met by actual cash must be left to the same organ that guarantees the prompt transformation of every cash token into actual cash.

VI. Furthermore, the function of making money and of issuing money are at times distinctly opposed, and the performance of these functions should lie in entirely separate bodies.

In developing these principles I am not unmindful of the fact that in Europe also there are countries where note issue is not entirely centralized. Changes in a monetary system have to be perfected with extreme care and patience, and everywhere it has been necessary to live through periods of compromise before finally reaching the coveted goal. In Germany, where there were thirty-two banks of issue, there are now only five, including the Reichsbank, which now, as a matter of fact, has become the all-important regulator. The other banks have been brought into a state of coördination where they have to coöperate in following the Reichsbank's lead.

We, too, shall have to be prepared for a period of compromise concerning note issue. We have before us a complex problem, inasmuch as there are at present in circulation too many inelastic and unsecured, or poorly secured notes, like the national bank notes, the greenbacks, and the silver notes. To convert at once any and all of them into the notes of the central organ would be too large an undertaking at this time. However, we may safely leave in circulation about half the amount now outstanding, to serve as the pocket money of the people, and begin by substituting the new elastic notes of the central organ for the other half. For elasticity means not only expansion, but also contraction. We must instill into our present system a sufficient amount of elastic notes—elastic because, being issued against bills purchased, they are withdrawn from circulation when the money paid for this paper at maturity is not reinvested in the purchase of other bills. If the bank cannot contract its notes in time of ease, it cannot expand as far as it should in times of stress. The principle ought therefore to be established that an ample portion of our present unsecured notes ought to be withdrawn and replaced by the notes of the central organ.

This, again, is not an impossible task. We have outlined in our previous plan how it could be accomplished by withdrawing the national bank notes and leaving the greenbacks and silver notes in circulation.

We could well imagine another plan,[1] which is advocated also by Professor Sprague of Harvard, in connection with suggestions now made by him for a modified form of a central bank. This plan would probably be more popular, though in my opinion not quite so sound. It is a scheme which would for the time being leave the national bank notes and silver certificates undisturbed and provide for the redemption of the greenbacks. The government would deposit with the central institution the $150,000,000 gold held against the 356 millions of greenbacks now outstanding. The central institution would

[1] *Quarterly Journal of Economics*, Feb., Aug., and Nov., 1910.

assume these greenbacks and we should suggest that it receive in turn the privilege of calling on the government in times of stress to pay for the remaining 200 millions, which the government would have the privilege of doing either by issuing to the central organization some short Treasury bonds or by paying in cash. This would enable the bank in case of extreme demands to place the Treasury bonds at home or abroad and break the pressure on its gold holdings. The surplus earnings of the central organization should be applied under this plan as a gradual redemption fund of the outstanding government bonds held by the national banks, and if, later on, it should be found necessary, the redemption of the government bonds in the hands of the banks might be accelerated by other means.

VII. No matter what may happen, not one additional government bond must be issued, carrying with it the privilege of further note issue by the national banks. While the national banks, which acquired these bonds in the past, are entitled to full and fair protection as to their present holdings, this reckless inflation of our currency system, which even to-day is a serious obstacle to monetary reform, must not be allowed to increase and thereby further weaken our miserable system.

VIII. Automatic taxes governing scattered note issues cannot bring about a safe and practical regulation. Conditions vary; a drain from within has to be met in a different way from a drain coming from without. Demands originating in healthy periodical economic developments must be treated in a different way from demands caused by over-expansion and over-speculation. In a large country covering the most varying geographic, social, and economic conditions, one ironclad tax, applied without possible discrimination to all alike at the same time, will do harm in one corner while it does good in another.

The system must provide for the use of brains and for a wise power of discrimination, though the regulative power must be so strictly circumscribed that there can be no other motive but the general good in deciding upon the questions as they arise. The elimination of any possibility of gain, the restriction of the functions of the central organization and the composition of its board will guarantee this.

One word in closing. With a structure as defective as ours, we cannot expect to develop at once an absolutely perfect new system. Monetary reform must try to perfect changes without violently upsetting existing conditions. The principles laid down here, and the details contained in my previous plan fully allow for this. The changes proposed leave the business of the banks and even their methods almost untouched. In order to do this, the so-called local principles must adapt themselves to conditions. However, there must not be the slightest compromise in two respects: The changes must err rather on the side of safety than on the side of immediate perfection and the fullest efficiency; and furthermore, they must contain nothing that is in contravention of those general principles which can be neglected only by endangering the whole structure.

Centralization of reserves, effective concentration of note issue, and fluidity of credit, strongly safeguarded, though thereby somewhat clumsy in the beginning, are the rules that must and can be observed. They are the only means of safely killing the germ distrust, or, to change the metaphor, of averting the ignominious struggle for life in a fire-trap. Unless we follow these lines we shall again see the sorry day when banks will trample each other to death in the mad attempt at saving themselves, till general suspension will put an end to this disgraceful scramble, marking in turn only the beginning of untold misery for the nation.

Slowly but surely it is becoming evident to the nation—and if the work of the Monetary Commission had accomplished nothing more, it would have done a great deal—that central banks are not oligarchic but democratic institutions, that central banks by creating safe conditions render the small banks independent of the dominion of the large institutions, and that in Europe the central banks are the backbone of the independent banks in their fight against the ever-growing branch-bank system.

A system of centralized reserves and decentralized banking power is clearly the one that this country requires, and it is my conviction that it will gladly accept it when once that system is clearly presented to it in definite form.

I have here avoided the name central bank, and have used the name central reservoir, just as in my previous articles I have termed the institution a central reserve bank or a united reserve bank. This has not been done from cowardice, for the purpose of avoiding a name against which popular prejudice ran high. It has been done for the reason that, first of all, the name expresses what is to me the most important feature of the problem, namely, the centralization of reserves. The second reason is that we should not have, and what we suggest is not, a central bank. Wherever central banks exist, their powers are infinitely wider; they are real banks privileged to do almost a complete general banking business. The central organization, on the other hand, as here suggested, though securing for us the principal advantages of the central bank system, is nothing but a central reservoir, precluded from doing a general banking business and invested only with such functions as it absolutely needs for its own protection and for the protection of the nation.

It has been a great privilege to be allowed to read this paper under the auspices of this Academy and the commercial bodies uniting with it in this national conference and under the eyes of the members of the Monetary Commission. We wish the latter godspeed. May success be with them and may they take up this momentous work without any further delay.

These years have been well employed in locating the evil and in clearly diagnosing the case. But now is the time to perform the operation, before the patient gets another relapse.

Let us hope that this question, which is non-partisan—for as far as we remember we did not find that Republican faces looked any different from Democratic ones during the panic —will be solved on non-partisan lines and that new nationalism will bury the hatchet before the vastly more important question of new national-bankism.

MAY, 1910

VIII

THE DISCOUNT SYSTEM IN EUROPE

IF banks were to keep, in cash, all the money deposited with them, business would come to a standstill and a crisis would ensue. If banks were to lend to those who apply for loans all the money on deposit with them, a general panic and collapse would follow a short period of overstimulation. Between these two extremes lies the middle course, the finding of which is the problem, and its practice—the art of banking.

No mathematical rule can state the correct proportion between reserves and demand obligations. The proper solution of this question depends in each country on its varying political and economic conditions and on its financial system. This general principle, however, may be safely laid down: with the present system of immense deposits payable on demand, and, by right, payable in gold, at the option of the payee, only that structure is safe and efficient which provides for effective concentration of cash reserves and their freest use in case of need, and enables the banks, when necessary, to turn into cash a maximum of their assets with a minimum of disturbance of general conditions. In this respect recent events have made it clear that our system is an unqualified failure. It is now generally acknowledged, even by those who were formerly most unwilling to concede it, that the end of 1907 witnessed one of the most impressive victories of the central bank system. More specifically, it was a victory of the "discount system" over the system of cash advances, because the central bank is only a component part, though a most vital one, of the discount system. A close analysis of the discount system, on which Europe's entire financial structure rests, may therefore be timely and interesting.

I

What is the essence and the object of "discounts"?

The original transaction from which discounts finally develop is an advance; it is either an advance in cash, or an advance in kind, i. e., the postponed payment for goods received. As evidence of this advance, and as an instrument on which to sue in case of default, the promissory note was created. So long as this note retains this primitive form and function it is of comparatively little value to the financial system of a nation. It represents nothing but a handy way of expressing an individual contract between two parties, embodying the acknowledgment of having received a temporary advance and the promise to pay it back.

Similarly, primitive part ownership in a business meant an individual contract, entailing a definite locking up of cash, inasmuch as such a contract could not be sold except after prolonged negotiation and search for a new partner. But gradual evolution led to the creation of the corporation, and the unsalable part ownership was transformed into bonds or stocks, for which important and well-regulated markets insured a ready sale.

A modern financial household is inconceivable without the adoption of such system of mobilizing permanent investments of this character. We are so accustomed to this phase of economic development that we find it difficult to conceive how comparatively recent an achievement this device is. Only a few, however, realize that we have stopped halfway. Although we in America have mobilized our permanent investments, our promissory notes, or temporary investments, still retain their primitive form, while Europe has not only mobilized its permanent investments, but has in addition mobilized its temporary investments by changing the promissory note, or "bill," into a "bill of exchange" and by creating large discount markets where these "bills" can be "exchanged" freely at any time.

"Discounts" represent—or, like our promissory notes, ought always to represent—temporary indebtedness which is to be paid off by the liquidation of the business transaction for the carrying out of which the loan was incurred. A bill may be drawn for cotton while it is being harvested, or while it is in transit for Europe, or while it is being manufactured into yarn, or while the merchant who purchased the finished article continues to owe the manufacturer therefor, or possibly even while the finished article is being shipped back to the same country from which the raw product originally came. To bridge each of these periods a long bill might properly be drawn by the various parties who, each in turn, handle the goods on their way from their original state to their place of final distribution. The length of the bill will depend on the underlying transaction; in England, France, and Germany it varies, as a rule, between two and four months, the vast majority of such paper being issued for three months.

With us the promissory note is, generally, one-name paper, while in Europe single-name paper is looked upon with distrust and is scarcely purchased at all by the banks. The European banker believes in having several signatures on the bill that he buys, thus securing more than one guarantee. Furthermore, additional signatures are evidence of the legitimate character of the paper and show that the money was taken for a temporary transaction, not for permanent investment. However, there are certain stages during the process of manufacture when the producer is not yet able to sell the bill on his prospective customer; or there may be good reasons why a business man will prefer not to divulge the name of his customers. For such and similar cases the European banks or bankers either allow overdrafts (cash advances) or else they permit the customer to draw on them a sixty- or ninety-day bill (whichever may fit the case) which, when accepted by the banks or bankers drawn upon, the customer can then sell at the ruling discount rate wherever and whenever he desires to do so.

Through the acceptance or endorsement of the merchant's note by the bank or banker the promissory note—from being a dead instrument and a nonliquid asset—becomes a liquid asset, part and parcel of the system of tokens of exchange which serve as a substitute for money or as auxiliary currency.

The old promissory note is nothing but the evidence of a commercial credit, the granting of which entails a material business risk and must remain an individual transaction to be concluded only by the few who happen to be well acquainted with the issuer of the note and are willing to take the hazard of granting that particular credit. Through the addition of the banker's signature the question of the maker's credit is eliminated and the note, instead of being a mere evidence of an advance, is transformed into a standard investment, the purchase and sale of which will be governed only by the question of interest. This investment commands the broadest possible market.

Acceptances are given by European banks and bankers mainly for three kinds of drafts: the documentary bill, the commercial credit bill, and the finance bill.

The documentary bill is probably the most important of these three. If an American merchant buys coffee in São Paulo, he will generally pay for it by opening for the shipper a documentary credit in Europe; that is to say, the American purchaser makes an arrangement with the European banker, by which the latter agrees to accept, let us say, a three-months' bill drawn on him with shipping documents attached, covering a certain shipment of coffee, the amount to be drawn being the equivalent of the amount due by the American purchaser to the South American shipper. The shipper will have no difficulty in selling to a bank in São Paulo his bill drawn on a first-class European banking house, and thus will promptly secure the money due him for the goods sold. The local bank in São Paulo will buy the bill without hesitation (if the shipper is not of the very best standing, the bank will demand that the letter of credit against which the bill is drawn be produced) because it knows that it need only send this foreign bill to England, Germany, or France, as the case may be, where, owing to the extensive discount market in these countries, it can immediately rediscount the bill, thus securing repayment in cash for the amount invested. Indeed, if the Brazilian bank prefers to do so, it can at the moment of shipment, by cabling to Europe, fix the discount rate at which the bills will be discounted upon their arrival in Europe.

When the bill reaches Europe, the drawee puts his acceptance on it, and having thus obligated himself to pay the bill when due, the documents are in most cases released and sent to the American purchaser of the goods, who opened the credit with the European bank. Of course, the American purchaser pays a commission to the European banker for the service rendered. The compensation depends on the standing of the purchaser and in part on whether or not the documents are to be released upon acceptance (the American purchaser obligating himself to put the bank in funds before the bill falls due), or whether or not the documents are to be given up by the accepting bank only against cash payment by the purchaser. It may be said that the average compensation for such acceptance credit is between ¼ of 1 per cent and ¾ of 1 per cent for three months, according to the conditions of the case. The majority of all shipments of merchandise, particularly those of raw material, are everywhere "financed" in this way by documentary bills on Europe. It is interesting to note right here that no matter how good may be the credit of the American purchaser or of any American bank, whose acceptance the purchaser may offer to the shipper in China, South America, or Europe, no shipper in such countries will, as a general rule, take the acceptance of an American bank or banker, because the American bill has no ready market, while the European bill is of very easy sale. It is impossible to estimate how large a sum America pays every year to Europe by way of commissions for accepting such documentary bills and the other bills with which we shall now deal, but the figures run into many millions. This annual tribute to Europe resulting from our primitive financial system is not merely waste of money, but reflects upon the dignity of a nation of the political and economic importance of the United States.

Next in importance to the documentary bill is the two- or three-months' bill drawn on a bank or banker as a commercial credit granted by the acceptor to the customer. This transaction is a comparatively simple one. It means that the European banker permits his customer, whether residing in the banker's own country or abroad, to draw on him at two or three months' sight, with the understanding that the customer will put the accepting banker in funds before the bill falls due, so that the drawee will not be called upon to advance any cash. He merely gives his signature to an acceptance, which the customer sells under discount, employing in his business the cash thus realized. The privilege of renewing the bill at maturity is often agreed upon at the outset, and the use to which the customer may safely and legitimately put the money realized from such a credit will in part depend on this feature of the arrangement between banker and customer.

Large business firms will, as a rule, have such accommodation at their disposal in several countries and they will draw against their credits on such countries as have the lowest discount rate for the time being. They may use all foreign credits at the same time when the interest rate at home is higher than the rates ruling abroad, and, conversely, they may at times cover all their foreign credits and use only the financial accommodation offered at home if for the time being the home rate is lower than the rates abroad.

The vast majority of these commercial credit bills are drawn without collateral, but there are many instances where the drawer of the bill gives security to the acceptor by the pledge of his own bills receivable or of claims against his customers or of merchandise or similar collateral.

The total volume of bills representing commercial credits given by one country to any other is relatively unimportant as compared to the amount of documentary bills issued, but large numbers of such bills are drawn by the home customer on the home banker, especially in France and Germany.

In England, banks and bankers generally avoid accepting long bills for home customers, whom they prefer to accommodate by cash advances, but they accept very largely for out-of-town customers. The joint-stock banks in England make it a rule to accept only against collateral, while important private banking firms and banks, which often make accepting their exclusive business, grant uncovered credits to a very large extent. In France and Germany no line of demarcation of this kind exists; banks, large and small, and private bankers as well, accept with or without collateral, according to their own best judgment. The aggregate amount that a firm in any of these countries will accept must, of course, bear a certain relation to its own resources. But this proportion differs according to the character of the general business done by such firm. A bank doing an extensive general banking business will accept to the extent of a part of its capital only, while banks or bankers devoting themselves exclusively to the business of accepting will accept an aggregate amount representing many times their own capital.

Since the rate for a three-months' cash advance is very much higher than the discount rate for three-months' bills, it is nearly always more advantageous for the customer to draw on the banker and to pay the commission for acceptance and, in addition, the European stamp tax, rather than to pay the rate of interest charged for a three-months' cash advance.

This heavy difference between the discount rate and the rate for cash advances most eloquently illustrates the different valuation applied by the European banker to an investment of easy sale—the discount—as compared to one that locks up cash for even the comparatively short time of three months in a nonliquid asset.

Finally we must mention the so-called finance bill.

Some finance bills are drawn and accepted within the same country, while some are issued in one country and drawn on another. The first class is drawn by home brokers on banks or bankers against stock-exchange collateral, which, for the time being, it is cheaper to carry by an acceptance credit than by a cash advance. But there is generally some discrimination against finance bills, as the idea prevails in the banking community that discounts ought to be based on short-time commercial or industrial transactions and not on undigested securities. The central banks in general absolutely refuse to buy such finance paper, and, as the prejudice against local finance paper is even stronger than that against foreign-born finance paper, the amount of such paper issued within the boundaries of each nation is comparatively small.

The foreign finance bill is drawn by a bank or banking firm in one country on a bank or banking firm in the other country, either with or without collateral. It is drawn in order to profit by the difference between the interest rate in the country where the bill is issued and the discount rate in the country on which the bill is drawn. A great many of these bills are drawn on France, where the interest rate is generally lowest, and on England, which, as a rule, has indeed a somewhat higher rate of interest than France, but which, on the other hand, is a more liberal acceptor, and finally on Germany. At certain periods the largest amount of such bills probably originates in the United States, being drawn chiefly on independent European banks or bankers against stock-exchange collateral. Very substantial sums, however, are drawn without collateral by American firms on their own branches in Europe. These so-called "house bills," which were very popular in the past, have during recent years met with a good deal of antagonism on the part of the European discounters, and in consequence are not used so freely as they were in years gone by.

The most regular customer in drawing finance bills is Russia, whose bankers, owing to the comparatively high rate of interest generally ruling in that country, almost constantly use whatever acceptance credits foreign bankers are willing to place at their disposal, the collateral generally being Russian commercial paper.

II

There are, then, two primary kinds of bills in use in Europe —the one drawn by the producer, manufacturer, or trader on his respective purchaser and accepted by the latter, and the other the bill drawn on and accepted by a bank or a banker.

Let us now consider how these bills are discounted in Europe. While methods differ in the various European countries, the result in all cases is the same, and, as we are chiefly interested in results, it will be preferable not to cloud the question by going into too much detail respecting the various usages, but rather to state the main principles.

Stated very generally, and fully bearing in mind that there are exceptions to the rule, it may be said that the bulk of the bills drawn on mercantile firms go to the banks or bankers direct from their customers, and it may also be said that these bills do not circulate very freely in the open market, while the bills accepted by banks and bankers are freely sold and circulate freely in the open market.

There are three kinds of purchasers of discounts in all important financial centers. One is the central bank of each country; the second is the banking community at large, which means banks, bankers, and brokers, who form the regular investors; the third is the irregular investor within and without the country.

The relationship between the central bank and the discount market is a most important one. While in normal times only a small proportion of the business is done by the central bank, the existence of this bank is all-important to the whole financial structure, because even if a bank makes it a rule not to rediscount with the central bank and in its general business keeps independent of this institution, the fact remains that in case of need it can nevertheless rediscount with the central bank every legitimate bill, be it a bankers' or mercantile acceptance, so that every legitimate bill represents a quick asset, on the realization of which every bank or banker can always rely. Consequently no investor, bank, banker, private capitalist, or financial institution will ever hesitate to buy good bills. Furthermore, there will not be in critical times any rush to sell good bills, as everybody in these countries knows that there is no better and safer investment, because for no other investment is there an equally reliable market. It is this confident reliance that creates the enormous discount market in modern financial centers and that renders it possible for untold millions of discounts to change hands daily, sometimes without any change whatever of rate or else with fluctuations of only $^{1}/_{16}$ or $\frac{1}{8}$ of 1 per cent per annum. The literal meaning of "credit" is confidence. Our whole structure is based on credit, or confidence, and not on cash. Unless this confidence is absolute—and it cannot be absolute under an admittedly defective system—the whole edifice is unsafe.

Another factor which helps to strengthen this confidence and to render the system perfect is the existence of strict and uniform laws concerning the issuance, endorsement, and collection of such paper, and particularly regulating the right to "protest" and promptly to sue the maker, the endorser, and the acceptor.

Finally, it is necessary for the development of a vast discount market that there be established a system of the freest exchange of money all over the country, rendering possible an easy collection of bills everywhere.

The central bank system of the various countries has been fully dealt with in separate articles, and we may therefore confine ourselves to stating only the general outlines of this system as far as it relates to the discount market.

It is one of the main duties and privileges of the government banks to buy legitimate paper, with bankers' acceptances or bankers' endorsements. As the government banks from time to time buy this paper, the volume of their circulating notes, which they issue in payment, increases, while, on the other hand, when they collect this paper at its maturity and thus reduce their holdings of discounts their outstanding circulation decreases. This means that they expand or contract according to the requirements of trade, because discounts represent progressive stages in the process of commerce and industry. However, this is not a merely automatic process, for when those entrusted with the management of the central bank see the necessity of exercising a restraining influence on the business community, they raise the rate at which the bank will discount, and in this they are generally followed by the other banks of the country. The government bank's discount rate, which is uniform for everybody, is, as a rule, so much higher than that of the general banks, and the restrictions as to the character of the paper which the government bank can take directly are so much more rigid than the requirements of the commercial banks, that in normal times the bulk of the business is done by the general banks and bankers. Only when the demand for money increases, does the rate of the general banks begin to approach that of the government bank, but when this happens the government bank, as a rule, raises its rate, so as to maintain its margin over that of the general banks.[1]

The government banks consider themselves more or less as custodians of the national reserve, ready to take an active part

[1] Some of the government banks at times establish a private discount rate, lower than the official bank rate. We shall, however, not enlarge upon this point in order not to complicate the question unduly.

in the nation's business only in times of emergency. The distinction should, however, be carefully observed between the abnormal crisis and what we may call the normal emergency, arising periodically in consequence of certain economic changes, like crop movements, or the particular requirements for special industries at fixed periods, which, as experience shows, subside as regularly as they occur. When these normal emergencies arise, the central banks do not ordinarily raise their rate, but, for a time, meet all the requirements at the usual, or at a very slightly increased, rate and allow their circulation to increase with the result that the reserves go down. When the government banks anticipate, however, that more than a normal emergency will have to be dealt with, they successively raise the rate in order to protect the reserve and to force liquidation, and in order to deter all branches of industry from entering upon far-reaching obligations.

Each government bank has a very decided interest in keeping its gold holdings as large as possible and in preventing the gold from leaving the country. If an augmented demand for money and credit accommodation increases the amount of notes outstanding, the government bank, by raising its rate, purposes not only to encourage a general contraction of business and to force the general banks of the country to contract, but also to attract foreign money into the country by the inducement of the higher interest return.

Most of the central banks in normal times accumulate large amounts of foreign bank paper. This is done for a two-fold purpose: First, in order to withdraw funds from the home market at a time of ease, thus creating a reserve; second, for the purpose of warding off withdrawals of gold by use of the foreign bills when foreign exchange rates approach the gold exporting point.

The relationship of the central bank and of the general banks to the discount market differs somewhat in the various countries. In France and Germany, where the big banks have taken up, more or less, all branches of the banking business, the intercourse between customer and bank on the one hand, and bank and central bank on the other, is a pretty direct one. While a large business is still done by brokers and consequently in the open market, a majority of the transactions is carried on directly between customer and bank and bank and central bank.

In England the various branches of business have, so far, been kept more strictly separated. The investment business in England is largely done through brokers. There are large check banks doing exclusively a deposit account business; there are certain firms devoting themselves almost exclusively to the flotation of loans, either international or domestic; certain other firms doing exclusively a business of acceptance (for documentary or covered or uncovered credits, as explained above); still other firms doing almost exclusively foreign exchange business, while certain large companies and private firms devote themselves entirely to the discount business; and finally there are the bill brokers, doing an intermediary business between the customer, the banks, and the discount companies.

The enormous amount of bills held by the discount companies and bill brokers in England is to a very large extent carried by them through loans on call from the banks. The banks regulate the average plus and minus of daily demands over daily maturities, to a large degree, by calling or increasing these call loans or else by buying or selling discounts. If, on balance, money is called from the discount companies or bill brokers, short bills will go to the Bank of England. In France and Germany, where the big banks have less hesitation in rediscounting freely with the central bank, the organization of discount companies and bill brokers is eliminated, and in order to settle the daily balances short bills are sent to the central bank directly by the banks.

It may safely be said that in normal times the big banks in

Europe do not rediscount their long paper with the central bank. For in such times maturing paper and money on call take care of the daily demands made upon them, and if the demand reaches larger dimensions they send their short maturities for discount and collection to the central bank. It is a sign of somewhat abnormal conditions and a signal for banks and central banks to exercise caution, if the bills discounted by the general banks with the central bank gradually change from short maturities to bills having a long time to run. It is of interest to know that the average life of all bills taken by the German Reichsbank in 1907 was thirty-two days, and of those taken by the Banque de France twenty-six days. The Reichsbank's investment in discounts was 13.8 per cent of the total of all discounts in circulation in Germany during that period; the Banque de France held 12.5 per cent of the total French circulation of discounts. Similar statistics concerning the holdings of the Bank of England are not available.[1]

Not only do banks and bankers invest in discounts, but financial institutions, industrial corporations, private firms, and individuals do likewise. Instead of keeping all their idle money on deposit, they invest a certain proportion in paper drawn on banks and endorsed by banks or discount companies, thereby giving stability to the whole financial structure. This is in striking contrast with conditions as they exist in this country, where unemployed money is to an excessive degree deposited with banks and trust companies, with the result that this idle money, which must earn interest, is finally piled up in the large money centers, especially in New York, and is there lent out on the stock exchange in the shape of call loans, forming an element of danger for the whole structure.

Moreover, the discount system plays a most important rôle

[1] On December 31, 1908, the Reichsbank held in German bills 1,032,000,000 marks; of these 44 per cent were payable within fifteen days, 17.4 per cent within sixteen to thirty days, 24.8 per cent within thirty-one to sixty days, and 13.9 per cent within sixty-one to ninety days.

as an equalizer between nations. Money flows where it can earn the best return, provided it can be invested there with safety and with a confident expectation that the investment can easily be resold and the proceeds of the sale easily collected.

If England has a private discount rate of, let us say, 4 per cent, and if, at the same time, there is in France a discount rate of 2 per cent, it stands to reason that the big French banks and the French public will invest in English bills, and that French money will go to England. The same holds good, of course, as to German, Austrian, Russian, or Scandinavian bills. The French banks would not buy the individual note of an English, German, Austrian, Russian, or Scandinavian merchant whom they do not know, but they do know and can value the acceptance or the endorsement of the foreign banks that offer and endorse or accept this paper. They would, however, not buy this paper, unless they knew that it could be rediscounted at any time in the home country.

Between the indebtedness of one nation to another and the actual settlement of that debt in gold, there lies, as a buffer, the borrowing power of the banking communities of the respective countries. This buffer with us has proved lamentably weak, because of our lack of a discount system. Because of this lack our bills are practically unsalable. It is not customary with us for banks or bankers to endorse and to offer for sale the promissory notes which they have purchased, nor is it customary for our banks and bankers to accept bills drawn on them, and so the United States has no American paper to offer which Europe could buy. Therefore when the necessity develops of temporarily attracting foreign money into the United States, there is nothing to fill the gap except our securities at bankruptcy prices and our "finance bills" drawn by our banks and bankers.

That is to say, the American banker, instead of adding his own credit to that of the American merchant or manufacturer and thus using the merchant's signature to legitimize his own demand for accommodation, locks up the unfortunate promissory note and secures for himself an entirely new credit on his own resources, quite independent of the original transaction, instead of simply infusing life into this dead note.

But our bankers' bills inevitably bear a financial character, and therefore will not be regarded so favorably as would be commercial paper; moreover, since the drawers and, to an even greater extent, the European acceptors are comparatively few, European bankers must at times limit their purchases for fear that they are getting too large an amount of paper drawn, accepted, and endorsed by the same firms.

Moreover, as these bills, drawn, as the case may be, in pounds sterling, francs, or marks, normally sell at the same rate of private discount as all the other long bills in the country, the European finds no particular inducement to purchase them. When, therefore, there is an excessive amount of these American bills offered, the consequence is discrimination and, what is worse, a feeling of uneasiness and distrust.

If, instead of this unfortunate method of financing, we could offer American paper drawn in dollars, showing its commercial origin, and endorsed by American banks or banking firms, we could vastly multiply the avenues leading into the vaults of the European banks, and our bills would be well distributed instead of going into a few channels which can so easily be closed, and which, as the past has shown, were very energetically and disastrously closed just at the time of our greatest need.[1]

[1] Our own system being absolutely inelastic, we have become accustomed to use as a substitute the power of our banking community to borrow in Europe. We thus use Europe as an auxiliary financial machine; but we forget that our weight has become so great as to threaten the safety of the European machinery when we are compelled to use it to its utmost capacity in order to provide for our needs. Europe, in sheer self-defense, refuses under those circumstances to let us borrow, and by the simple means of refusing our finance bills renders useless our reserve of elasticity. Thus, instead of securing ad-

What an anomalous and inefficient system which, instead of using the credit of the whole nation—producers', manufacturers', and merchants' credit joined to that of the financial institutions—demands that a few banks and banking firms should furnish single-handed the accommodation for a nation of ninety millions of people!

III

We shall now consider the discount system in its position as the basis of the whole financial structure, and contrast this system with our own.

The European financial system is constructed upon discounts as its foundation; the American system is constructed upon bonds and stocks as its foundation. Bank notes in Europe are issued mainly against bullion and discounts; in the United States mainly against bullion and bonds.

The quick assets held by European banks against their deposits consist of discounts or call loans, largely secured by discounts. The quick assets of American banks—promissory notes being unsalable and cash reserves being unavailable—are primarily call loans on stock and bond collateral.

In Europe the daily plus and minus of money requirements are adjusted by the use of the discount market—that is to say, in a final analysis, by purchases or sales of bills. (Calling in or putting out money on call, where the loans are secured by bills, amounts, in effect, to a sale or a purchase of bills.) In the last analysis this means that in Europe attempts to liquidate are primarily appeals to the whole nation to liquidate its temporary commercial investments, the brunt of such liquidation being borne by the entire community, and the pressure being constantly subdivided, every member of the community thus contributing his share.

ditional means of assistance at the most critical moment, we find ourselves suddenly forced to dispense with a most important part of our machinery, upon which we were wont to rely in normal times. This is what happened during the panic of 1907, and history will repeat itself, unless we adapt our system to our growth.

As a majority of discounts represent goods in process of production or on the way to consumption, liquidation of discounts expresses itself primarily by a falling off in new production, while the consumer, on the other hand, cannot stop consuming and must therefore continue to pay. The brunt is thus borne by the whole nation and adjustment follows without violent convulsions.

In sharp contrast with such a system the attempts to liquidate in the United States are directed primarily at the takers of stock-exchange loans. This means that a comparatively limited number of debtors are called upon to sell their securities. This they can do only by finding new investors, who, as a rule, are at such times comparatively rare, since when acute pressure arises it generally originates in the inability of the investor to purchase because of lack of funds or in his unwillingness by reason of his distrust of the financial situation. The concomitant of this is that those forced to sell securities at such times must offer them at sufficiently reduced prices to bring about an entire change in the attitude of the investor. The difficulty here is that violent reductions of prices in themselves cause distrust, and low prices caused by distrust not only frighten away purchasers but, in addition, unsettle the owners of securities and thus cause them to join the ranks of the sellers. An acute convulsion, therefore, must inevitably follow before the tide can be turned.

In order to bring about relief from strained financial conditions the depositor must be transformed into an investor and foreign money must be attracted into the country. To accomplish either the discount system is the most efficient means.

The insurance premium for each transaction is commensurate with the risk of the same. It is for this reason that an even moderately attractive interest rate for discounts in modern countries will attract the foreign capitalist and the home depositor, as both know that an investment in discounts can be realized at any moment without material sacrifice, and this is at the same time the explanation of the fact that, with our defective and explosive financial system, we must offer tremendous interest rates or our securities at bankruptcy prices in order to attract foreign money or turn the home depositor into an investor in critical times. Everybody knows that under our system convulsions must follow acute strains and must precede a cure, and therefore the average investor waits for the *débacle* before purchasing. And this attitude in itself accentuates the range of fluctuations, which, under the European system, is far less wide.

Of course, general liquidation in Europe includes a liquidation of securities, just as liquidation in the United States also includes liquidation of commercial paper as it matures. But the difference is that in Europe bills will be the main factor and securities will play a much more subordinate part, while with us just the reverse is true.

A few words ought to be said here about the disastrous effect of our obsolete usury laws.

There does not exist any law fixing the maximum rate of discount in any of the important European states. During the development of the central bank system attempts have at times been made to keep money rates low by compelling the central bank not to charge more at any time than a given rate. History shows, however, that such attempts have invariably ended in failure, and the fact is now generally accepted that the fixing of a maximum rate kills the efficiency of a modern financial system. Such a system requires elasticity and the theoretical possibility of adapting itself unreservedly to all conditions that may arise. The mere fact that the system provides for such means of free defense so strengthens the whole structure that where no such restrictions exist exorbitant rates are, as a matter of fact, the exception; while in a country like ours, where such restrictions prevail, abnormal conditions become a regular occurrence.

High call rates do not tempt either home or foreign investors, the latter particularly being barred from freely profiting by a high call rate by the fact that rates of exchange for remittances from one country to the other vary constantly, so that, unless the margin of interest can be secured for a fairly long time, at least a month, the profit in interest is not large enough to compensate for the risk of a possible loss in the rate of exchange.

It is obvious that, when European discount rates are higher than 6 per cent, we must be able legally to make time loans at rates exceeding 6 per cent, if we are to protect ourselves. Discount is time money on call, and in a modern community time money—not the call rate—is the decisive factor in the constant flow of money from one country to another.

Our usury law prevents the free development of rates for time money and incidentally prohibits the establishment of as wide a time-money market as exists in Europe. Since legally and officially our time-money rates can not exceed 6 per cent, the call rate, which is a fairly unimportant factor in Europe, must become the deciding factor with us. It is a most extraordinary (almost an amusing) fact that these call rates, fluctuating from a fraction of 1 per cent up to the confiscatory rate of 100 per cent and sometimes even more per day, and bringing ruin to the weak, should be the direct consequence of a law aimed at protecting the very people whom it destroys.

Usury laws in Europe, where they exist at all, apply only where the borrower is in dire distress when seeking and accepting a loan, and where the lender knowingly profits by the borrower's helpless situation when exacting usurious rates. Usury can be judged only in the light of the surrounding circumstances; and usury laws in Europe generally apply only to individuals. Our law, which prevents solvent firms of bankers, merchants, manufacturers, or brokers from contracting for money on time at more than 6 per cent, implies not only undignified tutelage, but unsound business judgment.

The recent crisis has shown that charging people in need more than 6 per cent is not necessarily taking advantage of them. On the contrary, it would have been a blessing to them, and in many cases their salvation, had they been able to borrow money even at a much higher rate. This unsound and completely indefensible usury law is, however, the reason why we must have daily settlements on the stock exchange, and why our system must in this respect also be strictly opposed to the systems of Europe.

In England, France, and Germany there exist monthly or half-monthly settlements of stock-exchange transactions, and as stock-exchange loans run from one settlement to the next, the amount of money employed on the stock exchange between settlements remains stationary. If, at the settlement, it develops that commitments on the stock exchange have increased and that a larger amount of money is needed there, so much additional money will under normal circumstances be withdrawn from the bill market and go into the stock exchange. If less money is wanted on the stock exchange, so much more will go into the bill market.

Without entering upon a discussion of the question of cash stock-exchange dealings versus stock-exchange dealings per settlement (for which, be it said in passing, a suitable method of weekly stock-exchange settlements can probably be devised for this country, combined with provisions for proper margining in order to prevent overstimulation or gambling), we are, for the purposes of this article, interested only in the effect of this method of cash dealings on the whole financial system. An exclusive system of cash dealings brings about the preponderance of the call loan on stock-exchange collateral. But for the existence of the seducing call loan, which is one of the gravest dangers and curses of our system, we should have been forced to develop our bill market as a regulator of our daily money requirements. In that case, instead of seeing the idle money of the whole nation poured into stock-exchange loans when trade is inactive—thus unduly stimulating speculation when it should be discouraged—and again withdrawing money from the stock exchanges in order to provide for the business of the whole nation when trade becomes active—thus bringing about anxiety and convulsions on the stock exchange in the face of prosperity—we should have a system based on bills; that is to say, based on the broad foundations consisting of the commerce and trade of the whole nation, and we should then enjoy an almost uniform rate of interest all over the country, gently rising and falling within moderate bounds, instead of the violent fluctuations and unbearable conditions to which we are now subjected.

The aggregate amount invested by a nation in trade and commerce should be and is many times the amount invested in stock-exchange loans, which latter represent undigested securities and securities carried for speculative investors. Our way of doing business may be illustrated by two adjoining reservoirs, one small and one very large. The small one represents the stock exchange and contains the call loans; the large one represents the general business of the country, as expressed by commerce and industry. In Europe the small reservoir is regulated by pumping water into it from the large one or by withdrawing water from it into the large one. In this way the outflow and inflow of the large reservoir are scarcely perceptible, and yet there is no difficulty in regulating the small one. With us, the reverse is done. If there is a shortage of water in the large reservoir we draw on the small one and, in order to increase the water in the large reservoir by perhaps an inch, we empty the small one altogether, or else in order to decrease the amount of water in the large reservoir by an inch, we fill the small one to overflowing.

Moreover, the discount system transforms into one large body of water a network of separate reservoirs, insufficiently connected with each other and each filled or emptied according to local supply or demand. The channel by which they are united is the discount rate, which would apply to bankers' paper alike in San Francisco and New York or in New Orleans and Seattle. It is a mistake to think that the size of a country will render such a system ineffective; for whether water is being withdrawn on one side of the basin and simultaneously added at the other far distant end, the surface of the water will be fairly level on both sides. In order to keep the height of the water within definite limits there is a strong main which brings additional water and a wide outlet to take care of the overflow; this is the function of the central bank. Where there are several faucets and outlets—that is, branch offices of the central bank—the effect may indeed be secured more rapidly and fluctuations in the height of the water will be somewhat smaller; but the equalizing power of the discount rate will remain the same. The benefit of fairly normal interest rates is bound to be reaped under such a system; it is only a question of the degree to which it is possible or desirable to secure this result.

Finally, we must dwell for a moment on the effect of the discount system on the highly important questions of reserves and of elastic note issue.

The central bank system and the discount system cannot be separated; they are absolutely interdependent. The discount system cannot exist without a central bank to which it may resort in case of need and, on the other hand, the central bank cannot exist without an efficient bank rate—that is, without the means of protecting itself and the nation through its power to influence upward or downward the general interest rates of the country. History has shown that without such power the central bank system fails.

The central bank must not be so intimately and so directly connected with the nation's general business that it can by its change of policy directly affect individual concerns. Between the central bank and the public there should be, as a buffer, the general banking community of the country, which should use its own credit and its own resources to modify the effect of changes in the bank rate, where the public cannot so quickly adjust itself to changed conditions. But the central bank must be able to influence the banking community sufficiently to enable it to regulate the general tendency of the money rates of the country. To achieve this is one of the functions of the discount system. With such a system, and only with such a system, can the most important further development safely be reached, viz., that of dividing the banking reserves of the nation into two kinds of reserves, the cash reserves and what we may call the working reserves.

Working reserves are represented by quick assets easily convertible into cash credits available to meet the demand obligations of a bank. Under a central bank and discount system these are the main reserves kept by the general banks.

Cash reserves are kept almost exclusively by the central bank, where they are available to permit the general banks to convert cash credits into actual cash whenever needed.

This system is based on confident and immutable reliance of the banks on the fact that against good and legitimate bills a cash credit is always obtainable at the central bank, and that no one will therefore needlessly withdraw or hoard cash. Capital invested in discounts, though considered as good as cash, yet draws interest, while capital invested in actual cash, besides entailing material risk in the safekeeping of the same, means a loss of interest. There is therefore no danger that cash withdrawn from one institution by reason of distrust of its solvency will be hoarded instead of being deposited in some other institution and thus finally reverting to the central bank without material delay.

Overstimulation of business, or other economic reasons, may bring about an increased demand for cash at home or an outflow of gold abroad. Such withdrawals of cash the bank will, as we have already seen, meet in various ways. But actual hoarding must be a thing inconceivable in a modern country organized to settle its enormous daily business with a comparatively small amount of actual cash.

To maintain the right proportion between the demand cash obligations of a nation and its holdings of actual cash is a task requiring the minutest study and the most constant care. In Europe this is the function of the central bank, which concentrates its attention and energies almost exclusively on this duty, and which should therefore be kept free from too intimate and direct contact with the general business of the country.

The general banks, on the other hand, organized to be money-making concerns and devoting their energies, as they do, to taking care of the requirements of the general public, cannot be expected individually to watch this problem of the cash reserves of the nation. Moreover, such a duty cannot possibly be performed by 21,000 competing institutions, which can protect themselves only by attacking one another. There must be one central reserve to which all unemployed cash will inevitably return, and to which everybody can apply, or an acute demand for cash will unavoidably bring forth hesitation to pay in cash, as happened with us during the last crisis. Hesitation in paying cash only increases the drain, which each bank can meet only by drawing on the reserves of the other banks, and if to these unbearable conditions there is added a foolish law (unavoidable under a decentralized system) which, by making it obligatory to keep 25 per cent of the deposits in cash, renders the cash reserves absolutely useless, there can be only one consequence, viz., runs by the public, runs by the banks, hoarding by the banks and by the public alike, and finally a general suspension.

If after a prolonged drought a thunderstorm threatens, what would be the consequence if the wise mayor of a town should attempt to meet the danger of fire by distributing the available water, giving each house owner one pailful? When the lightning strikes, the unfortunate householder will in vain fight the fire with his one pailful of water, while the other citizens will all frantically hold on to their own little supply, their only defense in the face of danger. The fire will spread and resistance will be impossible. If, however, instead of uselessly dividing the water, it had remained concentrated in one reservoir with an effective system of pipes to direct it where it was wanted for short, energetic, and efficient use, the town would have been safe.

We have parallel conditions in our currency system, but, ridiculous as these may appear, our true condition is even more preposterous. For not only is the water uselessly distributed into 21,000 pails, but we are permitted to use the water only in small portions at a time, in proportion as the house burns down. If the structure consist of four floors, we must keep one-fourth of the contents of our pail for each floor. We must not try to extinguish the fire by freely using the water in the beginning. That would not be fair to the other floors. Let the fire spread and give each part of the house, as it burns, its equal and insufficient proportion of water. *Pereat mundus, fiat justitia!*

But, to continue the metaphor, the central bank and discount system provides not only for a centralization of reserves and for concerted action in accumulating and in using the same, but it also furnishes the means of reaching and of creating a new supply of water.

Most of the central bank systems provide that a certain amount of bank notes may be issued against discounted bills. It would lead beyond the province of this article to state in detail to what extent each country requires bank notes to be covered by cash and to what proportion they may be issued against discounted paper. The principle, however, is observed in all countries enjoying a central bank system, that, as all bank notes represent demand obligations payable in cash, the amount of notes not secured by cash must at all times bear a certain safe proportion to the amount of cash held by the central bank.

In calculating the amount of cash required we must add to these unsecured notes the other demand obligations of the central bank, viz., deposits against which cash or bank notes may at any time be demanded, and which must, therefore, be treated as unsecured notes. As the Bank of England keeps a large part of its deposits invested in discounts, and not in actual cash, the same principle applies to it as to the German Reichsbank and the Banque de France, notwithstanding the fact that the Bank of England cannot issue any unsecured notes, while the other institutions named may issue a certain amount of unsecured notes. While the English system lacks the pliability of the German and French methods, and therefore requires more frequent and more energetic adjustment by changes in the bank rate, the main principles are the same in all three countries.

The bulk of the demand obligations of central banks, notes and deposits alike, so far as they are not covered by bullion, must be covered by discounts—that is, by promises to pay in bullion within a short time. They must be covered not by permanent but by temporary investments, so arranged that a very large amount thereof falls due every day and can thus be used to offset the cash demands made upon the bank. We have already mentioned that the holdings of the central bank consist largely of short maturities. The central bank meets the situation by collecting these as they fall due, keeping down the bank's new purchases by an increase in its rate designed to attract new purchasers of the long paper coming into the market, and at the same time to bring about a curtailment of business. Finally, it increases its circulation and temporarily reduces its reserves.

This means sound elasticity, based on discounts, and safely restricted by the proportion maintained between holdings of cash and of discounts.

Elasticity does not mean expansion, but expansion and contraction. Contraction, we are inclined to say, is even more important than expansion. Ability on the part of the central bank in normal times to decrease its holdings of discounts and to increase its reserves, without any material disturbance, is most essential to the system, because without such preparatory work the bank could not safely render assistance when called upon in active or anxious times. But the additional benefit of contraction is that it prevents inflation, with all its dangerous consequences.

This system is elastic not only in its structure; it is elastic also in its operation. This is a most important fact; for each situation must be dealt with on its own merits according to the circumstances of the particular case.

Thus, certain periodic and normal demands for cash, as well as a domestic drain caused by distrust, must be met by paying out freely. A foreign drain, on the other hand, must generally be met by an energetic increase of the rate, while a drain, both domestic and foreign, must be treated by varying combinations of both methods. The discount and central bank system enables the nation to meet these situations by concerted but varying action adjusted to meet each individual case. Is it credible that in a modern country like ours men should profess to believe that all these emergencies can be met by automatic, iron-clad rules, fixing a definite percentage of reserves and an adjusted scale of taxes, applied without possible discrimination to constantly varying and contrasting conditions, and the whole problem being complicated by the disconnected action of 21,000 competing banks?

Notes issued against discounts mean elasticity based on the changing demands of commerce and trade of the nation, while notes based on government bonds mean constant expansion without contraction, inflation based on the requirements of the government without connection of any kind with the temporary needs of the toiling nation. Requirements of the government should be met by direct or indirect taxation or by the sale of government bonds to the people. But to use government bonds or other permanent investments as a basis for note issue is unscientific and dangerous.

If the Panama Canal costs $500,000,000 we shall have $500,000,000 additional currency, whether the nation needs it or not. But what sane reason can be found to make the currency of the nation dependent on whether or not we build a canal? And why should we have more currency if we decide to build a sea-level canal rather than a lock canal? If we were not so well protected by our immense exporting power, we should suffer even worse and more frequent catastrophes through our system of issuing notes without maintaining a safe proportion between gold-secured and uncovered notes and through our device of a circulation not based on temporary investments and therefore incapable of contraction. There cannot be any doubt that a continuance of such a system must prove disastrous. The economic law that bad money always drives out good money cannot be safely disregarded, and it is only a question of time when its effect will show itself.

The Aldrich-Vreeland Bill, while only a temporary measure, is an important step in advance, inasmuch as for the first time it admits commercial paper as a basis for note issue; but this measure, even if enacted as a permanent law, cannot bring final relief, as the note issues not only remain decentralized, but, so far as based on discounts, are grafted on prior note issues based on bonds.

This means that having been forced to stretch a rubber band for so long a time and to such an extent that it has become inelastic, we expect to restore elasticity to this old and frayed band by tying to it a small elastic piece. But by so doing we shall only have lengthened the band, which can never contract within the length which has become inelastic.

If we compare the net results of the discount system with those of the bond-secured system, we find that in Europe rates of interest fluctuate within comparatively small limits, while the outstanding circulation constantly contracts and expands within wide ranges. With us it is the reverse. The outstanding circulation, once it is issued, remains fairly stationary, while the rates of interest fluctuate violently from 1 to 200 per cent.

The discount system enables the country to concentrate its reserves and to use them freely when needed; it brings about a clear distinction between the working reserves of the general banks and the actual cash reserves needed to protect the circulation of the country. With us such a line of demarcation cannot be drawn and our reserves become hopelessly decentralized and prove absolutely unavailable in times of stress.

The discount system recognizes the fact that issuing money and making money are two entirely distinct functions, which are at times antagonistic to one another. It is the duty of the money-issuing bank to restrain the money-making bank when the latter wants to go too far or too fast. Therefore note issuing and general banking are separated in Europe, the power to issue notes being more or less centralized. With us, on the contrary, general banking power and note-issuing power are lodged in the same banks, and the note-issuing power is not centralized.

In Europe an effective discount rate protects the country from foreign and domestic drains alike, while no such protection exists with us.

The discount system mobilizes the resources of the banks. It turns the bank's most legitimate investment, its commercial paper, into its quickest asset, and by so doing creates a new means of exchange, available both at home and abroad. Under our system investments in commercial paper are tantamount to a locking up of funds, which remain fixed assets till they mature. The discount system establishes a broad market for commercial paper and this market forms the basis of the note issues, and at the same time provides for an easy adjustment of the demand and supply of money, the burden being borne by the whole nation.

Under our system notes are issued against bonds, and the daily adjustment of the demand and supply of money spends itself primarily in an increase or a decrease of call loans against stock-exchange collateral. Contraction and liquidation mean an onslaught on the security market with resultant disturbances. It is a result of the foolish attempt to regulate the big reservoir by means of the small one.

There is an old banking rule that no bank may grant credit on other terms than those on which it receives credit. The truth of this adage is obvious and the extent to which this principle is carried out is the test of safe or unsafe banking.

Safe employment of the millions upon millions deposited with the banks is one of their foremost duties. The European system has adapted itself to this problem. Our system makes really safe banking an impossibility. An American banker invests his deposits in unsalable commercial paper and by so doing invests a call obligation in a time loan, which is bad and unsafe banking. As he is, however, practically compelled to do business in this way, he must, on the other hand, keep a large amount of assets on call in order to meet the first onrush of his depositors. In spite of the fact proved by our last panic, that, through the faultiness of our system, these call loans cannot always be depended on when called and are therefore not so available as cash, it is, nevertheless, the only conservative way in which an American banker can invest a large proportion of his deposit money—unless he buys foreign exchange and thus places his money abroad. Banks have been criticized for placing so much money in stock-exchange loans and the stock exchange has been criticized for absorbing so much money. Neither of them deserves blame. It is our system that has made the stock exchange the clearing house for the money of the whole nation and that has immobilized our commercial paper. It is our system that renders the banker helpless, leaving him to choose between the Scylla of locking up his capital and the Charybdis of adding to the accumulation of call loans on the stock exchange, thus placing further weight on this colossus on clay feet.

The discount system, by creating sound conditions, makes the small bank independent and safe. Under present conditions the small bank with us is dependent in critical times on the assistance of the large institutions and on the arbitrary will of the Secretary of the Treasury, limited as this assistance is by his (very uncertain) ability to help. The central bank, the backbone of the discount system, has everywhere proved a check to plutocratic monopoly.

We cannot close this short essay on the discount system without a few words about its historical development.

We are apt to believe, on this side of the ocean, that the European central bank and discount system have existed for centuries, that this system is the natural development of conditions as they exist in those countries, and that it was achieved without those radical changes in existing systems which with us would be necessary in order to modernize our system.

This is a mistake. As will be seen by the history of the various government banks, published by the Monetary Commission, conditions in almost all the countries now enjoying a centralized note issue were in former days similar to those which now prevail with us. Aside from the Bank of England and the Banque de France, it is safe to say that all the important central banks have been created within the last forty years. The discount system has been developed to its present importance only within the last sixty years. The immense accumulation of wealth during the last half century, the phenomenal growth of capitalization and of daily transactions, brought about the fullest development of every time- and money-saving device, such as checks, stocks and bonds, clearing houses, stock exchanges, and produce exchanges.

The mobilization of the promissory note and its development as the fundamental and most essential part of the whole financial structure is probably the most important phenomenon in modern financial evolution. Without it the far-reaching use of credit tokens as substitutes for cash is neither complete nor safe.

It is inconceivable that the United States, a nation that leads the way in industrial progress and that more than any other nation weeds out old machinery and replaces it by the newest appliances, should be either unable or unwilling to modernize thoroughly its financial system and to discard old-fashioned financial machinery, which other peoples have long since thrown upon the scrap heap. We are not invited at this juncture to suggest a solution for the problem involved in modernizing the American currency and banking system, but are asked only to report the facts. We may, however, state the case in this negative way: The question cannot be solved by simply copying one of the European methods; for our prospective system will have to be adapted to our own peculiar conditions. But, irrespective of the shape it may finally assume, any system we adopt will prove ineffective and disastrous, unless it be constructed on bills instead of on bonds, and unless it provides for a concentration of cash reserves and of the power to issue bank notes.

NOVEMBER, 1911

IX

CIRCULATING CREDITS AND BANK ACCEPTANCES

IN studying and teaching ancient history we lay great stress upon the names of kings and dates of battles while we unduly neglect the more important problem of how the people lived and what were their thoughts and ambitions. It is in considering this phase of history that we perceive most clearly the development of man and the progress of intellectual development, a process as yet by no means completed.

In dwelling upon such thoughts one cannot help recognizing as one of the most striking differences between primitive man and ourselves, that in the daily routine our ancestors took very little for granted, that everything they used and every manipulation they performed, they understood and did from beginning to end. In short, they were dependent entirely upon themselves. On the other hand, there is hardly anything in our daily routine that we use, or do, or even understand, from beginning to end. The activities of one day, even with the least developed of our fellow creatures, are indissolubly interwoven with those of millions of fellow beings whose products we eat or wear or use, and the most surprising feature of this evolution is that we have become quite unconscious of it.

Riding in the subway in the morning while reading our papers, do we think of the men who broke the coal, built the power-house, car, and track, and who operate them at the very hour, do we think of the thousand manipulations and inventions that produced our newspaper, and of the hands that wrote, printed, and distributed it? Do we, while we are reading, think at all that we are riding at the rate of sixty miles an hour? Does the tenant of an office on the thirtieth floor think of the thousands of devices that had to be invented and applied to make the sky-scraper safe and practicable? Does he stop to consider what would happen to him if the house were not fireproof, or if he could not rely on the elevators or telephone?

We have become accustomed to rely so completely on the perfection of all these appliances and the normal functioning of the thousands of hands which coöperate in serving us during the day, that unless there be a sudden stop of a wheel, we use them without further thought. To this class of appliances which it takes millions to compose and ages to develop, and which we use without thinking, belongs the thing so important to us all, the thing commonly called "money."

In a modern system we can no longer separate actual money from the many appliances that take its place in our daily routine; they are linked together and have all become essential parts of one big machine.

The modern banking system has been likened to a huge sky-scraper based on a comparatively small foundation of gold, and the many superimposed stories are represented by the immense number of all obligations payable in gold which, ordinarily, are settled by clearings of credits. The most evident and direct forms of circulating credits which have taken the place of actual gold are the bank note—forming a class by itself,—bank deposits, and checks. These are the main tenants of the towering structure. But they in turn have sublet a great many floors to all the other appliances for clearing indebtedness, all of which in the final analysis are being reduced to payments by exchange of bank credits. Time will not permit of dealing fully with the interrelation and the functions of all these tenants of the building; we shall only casually mention the most important phases.

A modern system aims at establishing standard values for which a broad market can be created, so that assets can be quickly turned into bank credits. This is one of the most fundamental principles of modern banking, of equal importance for depositor and banker. Our most important staples are no longer dealt in in individual lots, which must be personally examined before the bargain can be struck, but they have been standardized, and special exchanges have been organized in order to reduce merchandise to bank credits in the quickest way and to offset all purchases and sales so as to reduce to the minimum the actual use of money.

We have achieved the same perfection in dealing with stocks and bonds. While the original part ownership in a business could be transferred only by protracted negotiation and by finding a new purchaser who, after full examination, would take the place of the old owner, evolution has brought about the corporation, issuing stocks and bonds in easily transferable shape, so that these forms of investment and indebtedness also have been mobilized. They, too, have been developed into securities for which large special markets and organizations have been created, enabling the owner to transform his holdings with the greatest possible dispatch into bank deposits. In this respect stocks and bonds have become circulating credits; they are the means of transferring part ownership in, or the indebtedness of, a corporation from one owner to another in quick succession. But while the bank note and the check are clearers of credits on demand, stock and bond transactions are clearers of credits on time, or even for an indefinite period. They are only indirect and secondary.

The most important of the sub-tenants is the commercial paper. In a modern system the promissory note, running for a limited number of months, and representing some kind of a commercial transaction, has been mobilized by adding to it, by endorsement on the back, or by acceptance on the face, the banker's guarantee. Thus the old-fashioned "bill"—existing already in the form of bricks in the age of Hammurabi—is being transformed into a "bill of exchange." Thus an immovable investment is turned into a quick asset. The importance of this evolution is two-fold, because it is just as fundamental for the safety of the individual bank as it is for that of the whole credit banking system. The main assets of a deposit institution ought not to be stocks and bonds, nor loans on stocks and bonds, but commercial paper. But a bank, the deposits of which may be withdrawn on demand at any time, must have assets which can be reduced to bank credits within the quickest possible time and with the smallest possible loss, if any.

If a banking system, like ours, is built up on promissory notes which have no free market, the consequence must needs be that when deposits are withdrawn heavily, or when there is a strong commercial demand for money, stock-exchange loans must be called and holdings of securities must be sacrificed, these being the only available liquid assets. This means great economic waste and often calamity, for it is an absolutely perverse system that expects a *normal* investment demand, in times, especially, when money is scarce, to be able to supply a sufficient sum to satisfy all the immense commercial demands of the entire nation. Moreover, it follows that prices of securities have to be so far reduced that at bargain, or sometimes panic prices, an *abnormal* demand for securities at home or abroad will be stimulated. This method is not only wasteful, but, as the past has shown us, it is most dangerous. A modern system must provide the means which banks can rely upon to enable them to market their bills receivable, which represent the trade and commerce of the nation. In a modern system this can be done without appalling losses, there being no question of sacrifice of capital in selling securities, but only a question of difference in rate of interest in selling paper. Moreover, it can be done without creating a panic, since gradual liquidation of commercial paper means a reduction of the volume of all commerce and trade, which is adjusted by coöperation of every toiler and consumer. It is thus spread over a hundred million people, instead of falling back on the holders of stock-exchange loans and investors, few in number by comparison. While our system has remained entirely archaic and primitive in this respect, Europe enjoys the full advantages of a highly developed discount system, which averts panics there with as much certainty as we may expect their occurrence with us.

Commercial paper and bank acceptances form the main assets of European banks. These bills have the widest possible market, where millions are exchanged daily with margins of $1/16$ or $1/8$ of 1 per cent in the interest rate, without the necessity of scrutinizing the paper when the bargain is struck. Bills of exchange have been standardized, everybody in all parts of the globe knows what names of the many thousands that appear as endorsers and acceptors are considered as "good delivery," and everybody knows against which names there is discrimination. The daily differences are normally regulated in the case of European banks by means of larger sales of bills receivable or by larger investments in these bills.

The mobilization of the promissory note, the system which enables Europe to transform bills into bank credits as quickly as staples or securities, is the explanation of Europe's success where we have failed.

To insure safety for such a discount system, however, to render it possible and effective, a central reservoir for all the cash of the nation is necessary, as, inversely, for the safety and efficiency of the central reservoir a system of exchanging bills is a prerequisite.

If a system constructed upon credit is to be safe, the first condition is that cash must be less valuable or attractive than bank credit.

Holding of cash entails the risk of loss or robbery; it is a source of danger, like ammunition which we keep under our roof. Moreover, to keep cash unemployed means a loss of interest. Depositor and bank alike must therefore try to turn cash holdings into interest-bearing bank credits with the greatest dispatch and to the largest degree that may be possible and permissible. This alone will allow cash at all times to return freely and rapidly into a central reservoir, as provided by modern financial systems; this alone will allow the central organization to respond freely to any demand for cash, because the latter cannot fail to return through some other channel, unless it be taken for export.

But, in order to secure the free flow of cash into a central reservoir, it is a prerequisite that there must be absolute confidence (1) that there is enough cash to meet all emergencies, (2) that it will be freely forthcoming when demanded, and (3) last and most important of all, that the banks will be able, in case of need, to build up with such central organization a cash credit upon the strength of which they can withdraw cash, if such be required from them. It follows, then, that, under a modern system, there are two entirely different duties to be performed by the general banking institutions and the central organ. The former must see to it that they can command cash credits to meet their demand obligations, but it is the duty of the central reservoir to see to it that these cash credits be always transformed into actual cash when required.

The means, however, by which banks transform their assets into cash credits with the central organization are the rediscount of bills purchased, local or foreign.

Commercial paper, transformed into bills of exchange easily marketable at all times, forms the means of connection between the central organ and the banks; it constitutes the elevator system of the skyscraper,which alone renders the ever-growing tower safe and habitable.

This division of functions and this means of connection between the central institution and the individual banks cannot be too clearly understood.

In Europe, the general banks have no cash reserves, they have credit reserves. The duty to transform credit into cash resting on the central organ, it alone is concerned in the holding of adequate gold reserves and in watching that a certain and safe proportion be preserved between the aggregate demand obligations of the nation and its holdings of gold. The existence of such a strong supervisory organ and its ability to maintain the nation's credit creates that safety for the circulating credits of the nation which renders the whole system possible. For it is the confidence in these circulating credits which creates the broad market for money, always flowing where it can earn interest in safety, and it is in turn this free flow of money, attracted or driven away by a higher or lower rate of interest, which protects the central organ. By increasing or decreasing its rate of interest, thus taking a larger or smaller part in the nation's investments in commercial paper, by accumulating or selling holdings of foreign bills of exchange, the central organ exercises a regulative influence which keeps it strong enough to protect each bank individually in case of need, thereby safeguarding the whole nation.

Safety, from the point of view of banking investments, consists of two elements: the one, the intrinsic value; the other, its market. A consideration of these two factors produces the stipulation of the interest return that the investment must produce.

International money may flow to England and buy three months' British bank acceptances at $2^1/_{16}$ per cent, while for three months' English time money it would possibly demand $3\frac{1}{2}$ per cent; the difference between the two rates showing the difference in value between a quick asset and an investment for a definite period. But, even a comparative rate of 4 and 5 per cent could not cause international money to be invested largely in American commercial paper, since not only is it an unsalable, unliquid investment, but it has not been standardized. It is individual and provincial in its character, while the American banks which, knowing the maker of the note, might render it liquid and salable abroad, must not, under present conditions, freely endorse or accept it. Moreover, as long as there is lacking with us a central organ that would guarantee its market in case of need and secure at all hazards the transformation of cash credit into cash, foreign money will remain cautious and the interest inducement must remain comparatively exorbitant.

Contemporaneous financial history furnishes us constantly with illustrations showing the superiority of the European system. We have not only lived through the disgraceful collapse of our own machinery, but, quite recently again, we have seen the advantages of European financial methods. During the recent Moroccan crisis a war scare developed in France and actual hoarding of gold began; the withdrawals from the deposit banks were at a given moment alarming. But there followed no panic. The Banque de France issued notes freely, the French banks collected their holdings of foreign paper, and the general confidence in the Banque de France's power to cope with the situation overcame the fright without the calamities that would have ensued with us.

When France, for reasons just explained and as a means of political pressure, withdrew from Germany more than two hundred million marks that had been invested there, when English and Russian money was called back, when runs began upon some savings banks, Germany had to face a very severe strain. But what happened? The German Reichsbank rapidly increased its credit facilities by about $150,000,000; moreover, it had accumulated in times of ease vast sums of foreign bills, and when rates of exchange moved up to a point warranting gold exports, it began to sell these foreign holdings. At the same time a comparatively slight increase in its rate took place which brought new money, mainly American, to Germany's assistance. This inflow of foreign money was increased by the sale abroad of German treasury notes.

What would have become of Germany without the Reichsbank?

Without the confident reliance that the Reichsbank would be able to meet the situation and without its ability to apply all these various means of defense, general suspension would have been inevitable. It is the elasticity of such a system that renders it safe, and it is the implicit confidence that it inspires, that made our bankers send their money, without hesitation, in spite of a critical situation, in order to secure for a few months a beggarly ¼ to ½ per cent interest per annum more than they could have obtained at home. We had no war scare, the country was full of gold in 1907, but rates of 50 to 100 per cent could not bring money, because our system —or rather our lack of system—had killed our confidence in our own credit. We have no credit system, but a discredit system. The advantage of a big central organ, not run for profit like the general banks, but administered solely for the protection and safety of the nation, is plainly shown by Germany's recent history.

The complete withdrawal of money from "gainful occupation," turning it into idle cash to serve as means of legitimate assistance in times of need (a real and effective reserve in that respect, not a nominal one like our ineffective idle funds, which are termed reserves by a misnomer) and the quiet accumulation of foreign bills—less profitable than the German bill carrying a higher rate of interest—could be brought about and brought into effect only by such an institution.

It is the inefficiency and the discredit of our system which severely handicaps us also in our foreign trade; for a foreign purchaser will rather buy merchandise to be paid for in sterling than in dollars, and for the shipping of goods purchased abroad, be it in South America or Asia, the American merchant has to provide European bank acceptances, because the acceptance of the American banker, no matter how good his credit, has no market. We pay an annual tribute of millions to Europe for the financing of our trade, which is not only a wilful national waste, but also a blemish on our financial standing.

A wonderful change will take place in all these respects if the bill now in preparation by the Monetary Commission be passed on the lines suggested by Senator Aldrich. Without creating a central bank—for all the far-reaching banking powers have been eliminated which are characteristic of European central banks—and without fundamentally disturbing existing banking methods, merely by a simple device of federating the now scattered reserves into one general reservoir to be jointly administered for the protection of all, our system will be changed from a provincial, old-fashioned, wasteful, and dangerous one into a national, modern, economic, and safe structure.

Our system—at present a tottering, top-heavy skyscraper without a solid foundation—the tenants, instead of uniting in constructing a safe substructure, have solely concentrated their efforts on strengthening and fortifying each his own flat—a towering fire trap, provided with an old-fashioned staircase as the only means of communication for all its disconnected tenants—with one stroke becomes modern and safe. Or, as I said on previous occasions, the 20,000 to 30,000 scattered pails of water, representing our disconnected bank reserves, will be united into one large reservoir, with a system of pipes leading to every house, bringing safety to all by coöperation.

While the solution is simple in principle, it had to be complicated in form; for it had to satisfy even the most suspicious mind that control and abuse of power by individuals, singly or combined, political or financial, would be absolutely impossible, and it had to take into consideration that a modern discount system cannot be created by a stroke of the pen and that, therefore, a new device had to be invented to bring about a safe and effective mobilization of the present form of American commercial paper. Both will be achieved under Mr. Aldrich's plan. It is true that we shall have to create a machinery more cumbersome in operation and not quite so far-reaching in effect as the European system, but a careful consideration of all the details convinces the student that a simpler way would not be a safe one.

The plan, carried out on its present lines, will by process of federation bring about a centralization of reserves with a guarantee of decentralization of banking facilities. It will strengthen the independence of the smaller banks, and while restricting the National Reserve Association to the smallest possible field of operations, it will give to this association power enough to protect the nation in the future. It will bring about the mobilization of our commercial paper and, in encouraging bank acceptances, it will help us to finance our own trade, and to establish in doing so the first basis for the development of an American discount market, a step of the greatest importance for the future of our country. The National Reserve Association will be able to accumulate foreign exchange, and thus to act as a protector of the nation in times of need. It is also to be hoped that some way may be found to enable it from the beginning to meet emergencies by being in a position to sell short Treasury bills of the United States.

The National Reserve Association, if enacted into law, will take the monetary system of the United States out of Wall Street. Instead of a rigid system, the slight elasticity of which is now based on stocks and bonds, we shall enjoy an elastic system based primarily on commercial paper, bank acceptances, and foreign bills.

I have almost concluded my address without dealing with the bank notes which, as circulating credits—the subject matter alloted to me—ought to have been treated prominently. In beginning to study the subject of monetary reform one is apt to think that the question of note issue is the primary one. After some years of struggling with this problem, one learns to understand that the question of effective reserves and liquid credits is the main question, and that note issue is only a secondary phase and of lesser importance.

If any bank, rediscounting with the Bank of England, the

Reichsbank, or the National Reserve Association, may take gold against its credit balance, there is, from the National Reserve Association's point of view, no difference between this balance and a bank note against the presentation of which gold may be demanded. Bank notes are deposits in bearer form. The liability for bank notes and deposits is the same; for each deposit can be turned into bank notes, and each bank note into a deposit, and inversely; and for the same reason it is immaterial whether a general bank owns a bank note or a credit balance with the Bank of England, the Reichsbank, the Banque de France, or the National Reserve Association.[1]

Some of our leading financial papers appear not to have grasped this point fully. Because national banks are not allowed to count their own notes as reserves, it is argued that the notes of the National Reserve Association should not be counted as reserves either. But the difference is obvious.

The National Reserve Association could not count its own notes as cash; returning notes will not be treated as an asset, but will be charged off, reducing liabilities. In order to avoid confusion, our present national bank notes must be considered collectively in this connection. From that point of view national banks must treat their own notes, like checks on other banks, as clearing values; as assets but not as cash. The notes of the National Reserve Association are liabilities of an independent institution endowed with a huge capital and organized for the sole purpose of providing for the payment in gold of all its liabilities, including its notes. If the balance with such a National Reserve Association is to be counted as cash, as it should be, the note certainly must be counted as cash, too.

[1] Mr. Aldrich has very wisely, and I believe for the first time in banking history, made the liability a subject of measure and taxation—not alone the note issue as in France and Germany. To my mind the law would be even more perfect if the clauses taxing the note issue were left out entirely. In France and Germany, where an effective check system does not yet exist, note issue is the barometer of expansion, while with us and in England deposits play the more important part.

When one of our leading financial weeklies advanced the argument that such notes should not be counted as reserves because they are not so counted in Europe, it went far afield; for as we have seen, in none of the leading European countries is there any law requiring general banks to keep cash reserves, nor do these banks generally keep more cash than they actually need for their daily business. Neither could it strengthen the general system if they accumulated gold reserves. Quite the contrary, it would interfere with the free flow of gold into the central reserve where, becoming the basis of an elastic system, it can do vastly more for the efficiency and safety of the whole system than if locked away in a single bank. Since we possessed no central organ for the consolidation of our reserves, we had to have laws requiring each bank to accumulate reserves of its own. This archaic and unfortunate method can, however, now be turned to good account. For this direct coöperation in strengthening the reserves of the National Reserve Association—which coöperation, in this form and to this degree, does not exist in Europe—is all the more necessary since, through the lack of a highly organized discount system and through the restrictions placed upon the scope of its operations, the National Reserve Association would otherwise not command the strength and the confidence enjoyed by European central banks. In other words, with us the elevator service being less perfect—in the beginning at least—the foundation must be so much broader.

The fear that notes counted as reserves would attenuate the basis on which our banking system rests, would apply with equal force to balances kept with the National Reserve Association which, under the new plan, may be counted as reserves. This possibility of attenuation is the very element of elasticity.

It is the function of the National Reserve Association to see to it that all its liabilities—balances and notes alike—are fully protected by an ample supply of gold and by a credit so strong that nothing can shake it. But a system without the power to expand, no matter how large its gold holdings, remains vulnerable. Elasticity wisely safeguarded—as in this plan—is the basis of confidence and therefore of safety.

Not infrequently one hears the question: If it be true that the National Reserve Association will democratize our system and to a large extent turn the banks' call money into the bill market, taking it away from Wall Street, why should the latter favor the new law?

The answer is plain: This overflow of money, which in times of ease floods New York, and which, when needed, is withdrawn with such vehemence that it causes violent convulsions, is a constant source of danger to that city. While our present system makes New York the undoubted money center and gives to its banks a position of pre-eminence and predominance, this power is possessed only at the expense of a responsibility, which, with our present system, in times of stress brings mortification and humiliation. Wall Street, at present, is a ruler on a keg of dynamite. And, like many an absolute ruler in recent years, it finds it more conducive to safety and contentment to forego some of its prerogatives—thrust upon New York not by its own will, but as a result of our present laws and conditions—and to turn an oligarchy into a constitutional democratic federation.

But that is not all. We are a nation still in its formative period, full of ideals and ambitious imagination. It is not the hunt for the almighty dollar that prompts men, possessed of millions, to keep on toiling and struggling with nature and with their fellow creatures. It is the youthful and boundless energy craving for constructive success, the joy of creating and the conscious and unconscious desire of taking a hand in the triumphal development of this great country. Our ambitions are great, and it hurts our pride that, while we have become powerful, and are leaders in many respects, we are an object of contempt and of ridicule when it comes to the question of our monetary system. We cannot become a center of international finance on a par with European countries, until we reorganize. If New York has to make some sacrifice in order to achieve this aim, she is willing to do her share, just as every part of the country will have to contribute. Whatever little advantage may be lost in the beginning will be more than counterbalanced by the safety and continuity of our financial life. The United States enjoying a modern financial system will attain that place among the nations which should be hers by destiny, and she will weather in safety and dignity the storms, from within and without, that may be in store for her. A modern financial system will enable the banks fully and safely to finance the future growth of this country and, *vice versa*, a healthy growth of the country is bound to bring prosperity to the banks. The skyscraper placed on a solid foundation will safely carry many additional stories, and the tenants will be at once secure and prosperous.

OCTOBER, 1913

X

THE OWEN-GLASS BILL AS SUBMITTED TO THE DEMOCRATIC CAUCUS

Some Criticisms and Suggestions

NOW that we have before us the Owen-Glass Bill in the definite form in which it has been submitted to the Democratic caucus, it may be interesting dispassionately to analyze it and to establish wherein it differs from and wherein it agrees in the main points with the bill of the Monetary Commission.

It is a source of great satisfaction to note that, as the Republican party had to outgrow and to abandon its old doctrine of "currency issued by national banks against government bonds," so the Democratic party had to relinquish its old heresies of the 16 to 1 silver standard and the guarantee of deposits. Both parties are now agreed that reform must provide for "a currency"—to use President Wilson's own words—"not rigid as now, but readily, elastically responsive to sound credit, the expanding and contracting credits of everyday transactions, and the normal ebb and flow of personal and corporate dealings."

There is a further and even more important progress. Both parties have now recognized that it is not the "currency" which is the exclusive or even the chief factor that needs reform, but that, indissolubly interwoven with this question is the problem of rendering available and efficient the now immobilized reserves of the country, and of mobilizing and modernizing the now illiquid American bills of exchange by creating a "discount market" and "bank acceptances." Both parties are thus in agreement as to the ends to be striven for;

more than that, they are agreed even as to the technical means by which they must be attained. Accordingly, both plans provide for concentration of reserves, for the creation of an organization for the purpose of rediscounting commercial bills, for the substitution of an elastic note for the present national bank currency, and for a conversion of the 2 per cent government bonds into 3 per cent bonds.

The country is to be congratulated upon seeing these theories and principles clearly established; it remains the nation's duty conscientiously to watch that the aims now professed by both parties be carried into effect in the best possible way, and that they be not lost through ignorance, prejudice, or considerations of party policy. Where there is agreement as to the fundamentals, it should not be impossible to reach an accord as to the means, provided they be honestly sought for.

There were five main criticisms of the Monetary Commission's plan, and it is chiefly on these points that the Owen-Glass plan differs from its predecessor.

Mr. Aldrich's critics claim:

1. That there is too much concentration of power and that this power is placed almost entirely in the hands of the banks or their representatives.

2. That a uniform discount rate for the whole country would not be practicable.

3. That the size of the balances to be kept by the subscribing banks with the National Reserve Association is not defined.

4. That the National Reserve Association, after taking over all the 2 per cent government bonds, is not sufficiently protected, because, although it would assume the responsibility for the entire national bank note issue, it would be prevented from selling the United States 3 per cent bonds in case of emergency (except $50,000,000 per annum and that only after five years).

5. Finally, it is claimed that currency should be issued only

by the government of the United States and not by a semi-official body.[1]

As to point 1, the writer partly agrees with these critics; as to 2, 3, and 4, he entirely agrees; as to point 5, however, he totally disagrees with them.

Let us analyze each point consecutively:

The Monetary Commission's Plan proceeded on the theory of the Bank of England, which leaves the management entirely in the hands of business men without giving the government any part in the management or control. The strong argument in favor of this theory is that central banking, like any other banking, is based on "sound credit", that the judging of credits is a matter of business which should be left in the hands of business men, and that the government should be kept out of business. The Aldrich Plan, therefore, provided for only a moderate amount of government control; but on the other hand it restricted the powers of the central board and the scope of the branch boards to such a degree, and it proposed so democratic a system of electing directors, that its author hoped to satisfy the nation that the concentrated reserves of the United States and the note issue would be safe in the hands of this National Reserve Association. The Owen-Glass Bill proceeds, in this respect, more on the lines of the Banque de France and the German Reichsbank, the presidents and the boards of which are to a certain extent appointed by the government. The writer is inclined to think that the latter form is the one better adapted to modern nations. These central banks, while legally private corporations, are semi-governmental organs inasmuch as they are permitted to issue the notes of the nation—particularly where there are elastic note issues, as in almost all countries except England,—and inasmuch as they are the custodians of prac-

[1] This article does not aspire to be a comprehensive criticism of the Owen-Glass Bill in all its details, but has for its purpose the discussion only of these main points.

tically the entire metallic reserves of the country and the keepers of the government funds. Moreover, in questions of national policy, the government must rely on the willing and loyal coöperation of these central organs. Much is therefore to be said for the theory of centralizing reserves and note issue in the hands of a semi-official private corporation under a mixed administration of business men and government appointees, the managing officers being appointed by the government.

In strengthening the government control, the Owen-Glass Bill therefore moved in the right direction; but it went too far and fell into the other, and even more dangerous, extreme.

In France and Germany the central banks are entirely free from any sectional or political color. An officer is appointed on the strength of his qualifications, generally after a long training and gradually rising in rank; a director is elected on account of his standing in the business world; all irrespective of their political faith, and they will remain in office according to their merits and regardless of whether the liberal or conservative party is in power.

In our country, with every untrained amateur a candidate for any office, where friendship or help in a presidential campaign, financial or political, has always given a claim for political preferment, where the bid for votes and public favor is ever present in the politician's mind, where class prejudice and antagonism between East and West and North and South run high, in a country so different from these European states, a direct government management, that is to say a political management, would prove fatal. Moreover, in Europe the banks are not required to furnish the capital of the central banks, nor are they obliged to keep balances of such size as will be necessary with us, where the banks and the government will be the only depositors of the Federal reserve banks. The banks, therefore, should be satisfied that the administration will be carried on without bias and upon sound business principles. There can be no doubt but that, as drawn at present, with two Cabinet officers members of the Federal Reserve Board, and with the vast powers vested in the latter, the Owen-Glass Bill would bring about direct government management.

The Owen-Glass Bill provides for the creation of twelve Federal reserve banks as against the one National Reserve Association, with fifteen branches, as proposed in the Aldrich Bill. The National Reserve Association is theoretically the simpler, sounder, and, in effect, the more efficient structure. The freest possible return of idle cash into one large reservoir is best assured by a single organization, and its larger strength and uniform policy render feasible the creation of a real discount market and the performance of other functions, such as accumulation or disposition of foreign bills, and gold transactions, which are necessary for the safety of the structure.

Moreover, as we shall see later, a single organization of vast strength is in a position to solve in a more effectual way the question of government bonds and note issue. Messrs. Owen and Glass were moved to adopt the Federal Reserve Bank System, not only because Senator Aldrich had adopted the other, but because the absolute centralization frightened a great many who are afraid that in some way or other "Wall Street" might secure the key to this great chest. Although, in the writer's opinion, this apprehension was unwarranted, still this fear existed and had to be taken into account. Moreover, it was thought impossible to have one discount rate govern the whole country, and justly so.

In dividing the country into separate districts, each having its own Federal reserve bank and its own rates, it was hoped to counteract the danger of centralization of power and to render each district independent of the others. It seems that the framers of the law were in the beginning impressed with the idea of creating from twenty-five to thirty such centers, or even a larger number. The longer they dealt with this question, however, the clearer it became to them that the number had to be reduced and, furthermore, that some way had to be found to coördinate these separate entities, or rather to subordinate them under the domination of one central power.

It is clear that, if a large number of separate Federal reserve banks should be created without any such superimposed organ, instead of having a free back flow of idle cash into one center, we should have competitive hoarding of gold at each central point. This would destroy the basic principle of the plan, which is that the reserves of one part of the country, where there would not be any seasonal demand, should be available for another, where crops might just be moving. Without a central organ the result would have been that these independent and weak Federal reserve banks would have had to depend on the strongest among them for assistance. In other words, New York would have become the center dictating the country's financial policy, instead of having it formulated and carried out by a body of men from all parts of the country, as under the Aldrich Plan.

It became apparent then: first, that the number had to be reduced in order to make the units larger, and thereby more independent; and, second, that it was necessary to coördinate these units under a central board. Thus the number was reduced to fifteen, and later on to twelve, and the Federal Reserve Board was created. While these moves were in the right direction, they did not go far enough, for the proposition as it now stands is not as yet a practicable one. Let us see how it would work.

As an illustration we shall assume that a Federal reserve bank is established with the minimum capital permitted under the law, of $5,000,000 paid in, that is, a nominal capital of $10,000,000. This would presuppose a paid-in capital of the banks constituting this Federal reserve bank of $50,000,000. Let us assume that the deposits of these banks would amount to five or six times their capital, that is, $250,000,000 to $300,000,000. Of these 5 per cent would have to be paid in as balances with the Federal reserve bank, that is $12,500,000 to $15,000,000. Of these it should normally have no less than 66⅔ per cent in reserve, equal to $8,000,000 to $10,000,000, leaving about 10 per cent of the capital of the constituent banks, or $4,500,000 to $5,000,000 as available in normal times, and an additional 10 per cent for special demands; after which the limit of a gold reserve of 33⅓ per cent would have been reached. This illustration presupposes that the banks, having paid in 10 per cent of their capital, would want to reimburse themselves by rediscounting an equal amount with the Federal reserve bank, which means that the capital of the latter would be normally invested. But assuming that the capital would be uninvested, the total amount available for the accommodation of the constituent banks would even then be only 30 per cent of their capital.

This permits of several conclusions. It shows, first, that while the Aldrich Plan left entirely optional with the banks the size of the balances to be kept with the National Reserve Association, permitting them to count both balance and lawful money in their vaults as reserve, the Owen-Glass Bill, while correctly stipulating a minimum balance of 5 per cent of the deposits, errs in setting at the same time a minimum limit also for the amount of actual cash to be kept in the vaults of the banks. From the point of view of strengthening the Federal reserve banks, and thereby the banks themselves, the balances with the Federal reserve banks, that is their cash holdings, ought to be increased as much as possible. The banks ought to hold only as large or as small an amount of actual cash as they actually need for their daily business, and all unnecessary cash should be deposited with the Federal reserve banks. Allowing for an ample supply of till money, but leaving the determination as to its size to the free judgment of the banks, it is safe to estimate that the aggregate gold holdings of the joint Federal reserve banks could be increased by some \$200,000,000. The joint loaning power would thereby be strengthened by twice that amount. In estimating this increase it has been assumed that an amount equal to at least 2½ or 3 per cent of the aggregate deposits could be safely counted on. In our illustration this would mean that about \$7,500,000 would be added to the funds of the Federal reserve bank, of which \$2,500,000 normally, and a maximum of \$5,000,000 would become available for the contributing banks; which would increase the total to 40 per cent of their aggregate capital. The very object of the law should be to reduce to the smallest possible sum the amount of cash hoarded in the banks and to increase to the largest possible size the concentrated reserves in the Federal reserve banks. But it would be a mistake to attempt at this time to do more than to free and to consolidate the cash reserves, now wastefully impounded in the banks. It would be inadvisable to add to these vast sums substantial portions of the cash balances now kept with reserve agents as part of the legal reserves. These balances are now actively employed by the reserve city and central reserve city banks; if withdrawn from these banks and replaced by actual cash in vault, or by balances with the Federal reserve banks, the accommodation heretofore granted to the community by the reserve city and central reserve city banks will have to be provided by the Federal reserve banks; that is to say, the regular business done by the banks will have been taken away from them, and the Federal reserve banks, which properly should act primarily as reserve institutions, providing the elasticity for extraordinary demands, will have been forced into the normal business, from which they should try to keep away.

Unless it be clearly understood by legislators and banks that the Federal reserve banks must not be used in normal times to finance the country to any substantial degree, the latter will fail to serve their purpose, because their funds will not be available when the real "pinch" comes.

The balances with reserve agents should therefore be left undisturbed to a certain extent, or if we are to break with the old system of counting one bank's balance with another as a cash reserve, on the ground that such balance really is not cash, then we must concede that our system, as it stands to-day, implies a reserve of only 6 per cent for country banks, of 12½ per cent for reserve city banks, and of 25 per cent for central reserve city banks. It is with these actual cash reserves that the nation's banking business has been done, and, if properly organized, we can safely assume that they would be sufficient. No other nation requires cash accumulations or balances with central banks of such size.

If the new law eliminates these bank balances as reserves, it ought to provide for a corresponding reduction of the reserve requirements; not to the full measure of these bank balances, because a certain degree of liquidity was assured by the old system, but to a large extent.

It would appear entirely practicable to reduce the reserve requirements of the country banks from 15 per cent (of which 6 per cent were in vaults and 9 per cent with reserve agents) to, let us say, 10 per cent of the reserve city banks from 25 per cent (of which 12½ per cent were in vaults and 12½ per cent with reserve agents) to 17 per cent; and of the central reserve city banks from 25 per cent to 20 per cent.[1] The law should then provide that of these reserves a balance of no less than 50 per cent would have to be kept with the Federal reserve banks. This would mean a minimum of 5 per cent for country banks, of 8½ per cent for reserve city banks, and of 10 per cent for central reserve city banks. The writer has, however, no doubt that the balances would in fact be much larger, because there would not be any reason for the banks keeping more cash at home than they actually need for their daily business. On

[1] Provided there are only a few central reserve cities; if there were more than four or six there would not be any justification in requiring them to keep reserves so much larger than the other cities.

the other hand, the size of the balances generally kept by a bank with the Federal reserve bank—and thereby for the benefit of the entire community—would have some bearing on the consideration which, in case of need, may be claimed from the board of the Federal reserve bank. But whether this suggestion be adopted or not, there can be no doubt whatsoever that nothing can be gained by impounding an unduly large amount of cash in the vaults of the individual banks, or by unduly locking up their now free funds. If properly consolidated and organized, the present cash reserves ought to prove sufficient; if linked together in an unsound and inefficient manner, the inclusion of the bank balances will not avail. If, after a few years of active operation, it should become necessary to increase the balances, the law can be easily amended to that effect. But it is most important to avoid all unnecessary convulsions at the beginning.

As the law is now framed, our illustration has shown that probably eight out of the twelve Federal reserve banks, thrown back on their own power alone, would not be able to provide the necessary facilities during seasonal or abnormal demands. The smaller the circle for each Federal reserve bank, the more acute would be its embarrassment, because the demands of its constitutent banks will be simultaneous, the dominating industries of the region not being sufficiently varied. The larger the circle of each Federal reserve bank, the stronger must be its own intrinsic power.

But even with larger units than are provided by the Owen-Glass Bill, the law would not achieve its purpose unless it ultimately brought about a market for bills and bank acceptances and a free and natural interplay of reserves between the various centers. The business normally done by central banks must be only a fraction of the aggregate discounting done by the general banks, banking firms, corporations, large and small, and in particular by foreign banks and governments. When the cotton crop is to be moved, not only the southern

Federal reserve bank or banks must provide their limited share, but the local banks in those parts of the country where money is not in so strong demand during that season should be ready to buy southern bills. In doing so they would rely on their own ability to rediscount in turn their own short maturities with their Federal reserve bank or depend upon the broad market for discounts, in which they could in case of necessity resell these bills with their own endorsement. Can such a market, which is an absolute prerequisite for the safety of the entire structure, be developed with a system of twelve Federal reserve banks as now proposed? The answer is a most unqualified "No."

The basis of a discount market is confidence; confidence in its large absorbing power and in its reasonable rates. By "reasonable" I mean to imply rates that can be foreseen by "reasoning," by summing up all the natural influences—and the extraordinary ones too—that may contribute to shape money rates in a rising or falling direction. Both these elements would be lacking under the Owen-Glass Plan. With twelve discount rates (even though a good many might be generally the same), with twelve competing centers, with twelve conceivably different discount policies, a large discount market cannot develop. A market develops where purchasers and sellers meet. Locally the majority of the small finance centers will be purchasers; but, as between the various centers, they will on balance almost invariably be sellers. No open discount market will therefore develop in such smaller centers. It could, however, develop in the large centers like New York, Chicago, St. Louis, Boston, and Philadelphia, if it were not for the arbitrary powers vested in the Federal Reserve Board.

If, at these large centers, the banks could rely on a natural development of the discount rates, they would not hesitate to invest freely in bills instead of keeping their working reserves (not the legal ones) in "on-call money"; but what means have they to cast any reasonable prognostication as to the course of such rates? The New York Federal Reserve Bank's position may be very strong and the Federal Reserve Banks at Boston and Chicago may be in an equally good condition. Eastern banks might therefore be quite willing to buy southern paper at 5½ per cent, while the official bank rate of the Federal Reserve Bank at New York presumably might be 5 per cent and that at New Orleans 6 per cent. But here comes the Federal Reserve Board and issues its edict that the Federal Reserve Bank of New York rediscount $10,000,000 each for the Federal Reserve Banks at New Orleans, Seattle, Kansas City, or perhaps, Denver, Salt Lake City, Minneapolis, or Duluth. To what extent these demands will be made and on whom they will be made, whether on New York, Chicago, or Boston, no banker will be able to foretell, nor will anybody know to what points the money may be directed. In the face of such conditions the call-money market will remain the standby of the banks; for they will not incur the risk of investing in discounts while the discount rate, instead of developing according to the natural free flow of credit and money, jumps according to the whim of a largely political body. With an election coming—and an election is always coming in the United States—how strong a probability is there that a demand from Seattle or Dallas (be they over-extended or not) for money from the East will be refused? How strong a probability is there, in the face of some political agitation, that a depleted New York would receive money, even were it its own, from the South or the Far West? And even if the majority of the men constituting the Federal Reserve Board were entirely free from political considerations (which they cannot possibly be because some are political officers and owe it to their party not to disregard the political aspect of the case), what training, what ability would they command to pass upon these business and banking questions so as to enable them actively to run the banking business of the entire country? For not only is the discount rate of each Federal reserve bank "subject to review" by the Federal Reserve Board; not only has this Board the power of throwing the reserves from one part of the country to any other part that it pleases; but the Board will fix at its own discretion the rate at which "Federal reserve notes" will be "advanced" to the Federal reserve banks. To this question we shall have to revert later.

While it is true that, by the addition of the Federal Advisory Council, a very commendable improvement has been made, because through it the Federal Board will have an opportunity of at least learning facts concerning general conditions which otherwise it could not possibly know (though it remains entirely optional with the Federal Board to act on these facts, or rather upon local or political pressure); while it is true, furthermore, that the arbitrary powers of the Federal Board have been somewhat "toned down," none the less the proper working of the entire system will depend upon the wisdom with which the Federal Board exercises its functions, in particular that of "permitting or, in time of emergency, requiring Federal reserve banks to rediscount" paper of other Federal reserve banks.

It has been argued with great insistence that the Federal Board should not be clothed with the power of *requiring* Federal reserve banks to rediscount for each other; but it is the weakness of the entire plan that without such power lodged in some group of men the whole structure would fall to the ground. With twelve Federal reserve banks the *permission* to rediscount for each other is a theoretical option of which they would hardly ever avail themselves. If the Federal Reserve Bank of New Orleans should happen to have a bank rate of 6 per cent, against rates of 5 per cent in the majority of the other zones, and if the Federal Reserve Bank of New Orleans became crowded, facing the necessity of increasing its rate to 7 or 8 per cent, what would happen? Would New England or Pennsylvania or Chicago or New York of their own accord apply for permission to grant a loan? If money should be plentiful in these regions, the boards of these Federal reserve banks would argue that their individual constituent banks should take as much paper from the New Orleans banks as they thought safe and good business, but they would not for a moment consider it wise or incumbent upon themselves to weaken the reserve power of their own Federal reserve bank for the benefit of the New Orleans Federal Reserve Bank, shouldering thereby a burden which would otherwise fall on the remaining ten Federal reserve banks. In order to avoid the semblance of a central bank, the structure has been torn into twelve separate entities; but as the majority of these units are unable to stand alone, and as safety lies in union only, there must be some arbitrary power to take the place of the links that are missing in the structure. The further decentralization has gone, where centralization is the end to be sought, the vaster and the more arbitrary those powers must be.

With twelve units, for the deliberation and coöperation of which with one another the law does not contain any provision—excepting the Advisory Council, which may advise the Federal Board but may not act—the initiative and executive power for any joint or individual action between these Federal reserve banks must rest solely with the Federal Board.

This is most unfortunate, because for these seven outsiders, who constitute the Federal Reserve Board—outsiders because, living in Washington, they all stand outside of active business and they cannot possibly ever be in direct touch with it—it is a problem beyond any man's power to decide wisely which of these twelve Federal reserve banks is to receive a rediscount and which of the remaining eleven, and in what proportions, shall grant the same.[1]

[1] The law provides "that the interest charge to the accommodated *bank* (we take this to mean the accommodated *Federal reserve bank*) shall be of not less than one nor greater than three per centum above the higher of the rates

There will, therefore, be no natural flow of reserve money, nor any free flow of money, into these disconnected discount centers. Important open discount markets will not develop; because neither Europe nor the large American banks will trust a system of this kind, which does not insure a sufficient mobility for commercial paper. Consequently the banks will not be enabled to dispense with their present habit of keeping a substantial proportion of their assets in loans "on call." For the sake of creating some provincial centers, which will be centers only in name, and which, standing alone, will not be able to provide the needed relief, the efficiency of the whole system will have been sacrificed.

But while a system of twelve Federal reserve banks will prove a failure, it will be well-nigh an impossibility to reduce the number later on. It is difficult to withdraw privileges once granted, even though their elimination would be of general benefit. On the other hand, it would not be hard at any time to increase the number, if this should prove advisable later on. Meanwhile, under a system of a small number of Federal reserve banks, discount markets would have developed, and the nation would have an opportunity of judging itself whether or not those were true prophets who predicted that the "discount market" would remove the concentration of money on the stock exchange, and whether or not the fear of a "tyranny of credit" will survive under the new system.

There are further phases of this problem that we must consider:

prevailing in the districts immediately affected." This must be a mistake. If New Orleans's "bank rate" is 7 per cent, its Federal reserve bank can take discounts only at the uniform rate of 7 per cent; why then should it sell its assets at 8 per cent or 10 per cent in order to accommodate at 7 per cent some banks, conceivably those that have expanded too much? If the Federal Reserve Bank of New Orleans can borrow only at 8 per cent, its bank rate should be not only at least 8 per cent, but rather higher in order to keep down the expanding banks of the region and in order to draw money into the dry district from other banks of the United States or Europe.

The Owen-Glass Bill contains elaborate provisions for the development of bank acceptances and for dealing in foreign exchange. Both provisions are most appropriate, for without creating an effective machinery covering these two items the law would not achieve its aims.

If we want to finance our own foreign trade, if we want to establish a standard banking paper with a large market at home and abroad, great pains must be taken to develop these bank acceptances (not only those of subscribing banks, but also of our private firms; for the banks alone could not provide all the necessary facilities.) The accepting bank receiving a commission of between ¼ and ½ per cent for giving its three months' acceptance, the discount rate for bank acceptances will have to be about 1 to 1½ per cent lower than the rate for single-name promissory notes. Though it would be better business for the Federal reserve banks to buy 45-day paper at, let us say, 5½ per cent, they will have to make it a point to have a private discount rate for bank acceptances of, let us say, 4 per cent. This private discount rate must meet English, French, and German rates in the world market, and, unless the Federal reserve banks make special efforts to make the American rate reasonably low, no American bank acceptance will take the place of the European ones, no matter how many foreign banks may be established under the American flag.

Which of the twelve Federal reserve banks is to carry this burden? They all will want to earn their 5 per cent, for which the margin does not appear to be very large as the bill is drawn at present, and they all will strive to make the surplus earnings beyond 5 per cent as large as possible, since they are to receive 40 per cent of such excess. There are several reasons, however, why the 5 per cent dividend is not so amply assured as it was under the Aldrich Plan: (1) Under the latter plan, the Treasury money was deposited free of interest, while under the Owen-Glass Bill interest is to be allowed to the Treasury.

(2) Under the Aldrich Plan the profit on over $700,000,000 of national bank notes, which were to be assumed by the National Reserve Association, and the profit on any further note issue, was to go to the National Reserve Association. Under the Owen-Glass Bill the Federal reserve banks will have to pay interest on the notes to the government, so that it may not be sure that any profit will be derived by them from this source. While the National Reserve Association's profit was limited to 5 per cent, the balance going to the government, the margin was so large that all transactions which were to be done for the public welfare, with small profit or even at a loss, could be carried out without encroaching on the 5 per cent dividend. It is a fair question whether, in view of these conditions and considering the vast powers of the Federal Reserve Board to interfere with the profits of the Federal reserve banks, the government should not guarantee a minimum return to the stockholding banks—let us say 4 per cent as maximum and minimum—permit the banks to dispose of their stockholdings at pleasure, authorize the Federal reserve banks to sell the stock to their members above par, and to use the premium for the establishment of a surplus fund.[1]

If we review our considerations at this point, we find that the result of the division of the country into twelve Federal reserve banks, under the Owen-Glass Plan, would be the destruction of a reliable and strong discount market, the weakening of the reserve power of the country, the undoing of the hope of developing on a broad basis the American bank ac-

[1] The plan of permitting the Federal reserve banks to participate in any profit secured in excess of 5 per cent does not appear to be sound. It would act as a stimulus toward activity and money making, where the main duty of these Federal reserve banks must be conservatism, and a strong tendency to remain in reserve without any consideration of sacrifice of profits.

It would be better to allow the stockholders a return of 5½ or 6 per cent, under a liberal system that would permit them to earn this dividend even with the greatest conservatism, than to permit them a share in the excess profits under a narrow system that would rather force them to do business in order to be quite sure of even their 5 per cent dividend.

ceptance, and the sacrificing of a strong and efficient foreign exchange and gold policy. On the other hand, while all these advantages of a frank centralization have been lost, the Owen-Glass Plan cannot avoid the same degree of centralization, which, however, it brings about by conferring autocratic powers upon a small group of men. And because the technical decentralization into twelve units has gone too far, the individual powers, which are to take the place of the well-knit links of a single organization, must necessarily be too far-reaching. They become a danger to the whole structure and, at the same time, to those who are to be the responsible officers of the Federal Reserve Board.

The remedy is a simple one. If the framers of the Owen-Glass Bill, continuing in the same direction in which they have moved up to the present, will further reduce the number of the reserve centers, the very serious objections to the present law may easily be eliminated.

In the writer's opinion a system of four Federal reserve banks, with centers at New York, Chicago, St. Louis, and San Francisco, with a Federal Reserve Board at Washington, would under the circumstances form the best possible solution. If it be objected that by such a division New York, which would include New England, would become too strong, a system of six Federal reserve banks would still be practicable, though less safe and efficient. Any larger number the writer strongly believes to be pernicious. It may be well to bear in mind that with any further increase in number of the Federal reserve banks, New York's weight could not be much reduced, and the larger the number of the Federal reserve banks, the more acute will become the disproportion of New York's power as compared with that of the other centers.

Let us now contemplate how a system of four or six Federal reserve banks will meet the various difficulties that we have discussed. For simplicity's sake we shall discuss a system of four Federal reserve banks, but if six should be decided upon, the argument, though weakened, will still remain the same.

A system of four Federal reserve banks would offer to the people a guarantee that New York could not in any way have any direct influence upon the management of the banks in the other parts of the country. (The New York Federal Reserve Bank would embrace New England, New York, New Jersey, Pennsylvania, Delaware, and Maryland.) The country would be as safe in this respect as it would be under a system of twelve reserve banks. On the other hand, what have we gained? The accumulations of reserve money would be so strong in each of the four centers that a sectional seasonal demand could be readily taken care of; all the more because with four large units, four powerful administrations with a distinct and strong policy, important discount markets would develop. We should then have a real concentration of reserves and a real mobilization of credit. These four reserve banks could agree upon a joint handling of bank acceptances, foreign exchange, government bonds, and note issue, (perhaps for joint account to be based upon the capital of each Federal reserve bank). Four large concerns will be able to agree upon a disinterested policy; twelve local Federal banks, with unequal powers, and naturally more selfish interests, never will. The idea prevails among some critics that twelve centers will take better and fairer care of the country than four. This idea is unfounded. The reverse is the case. The question of the branches of the National Reserve Association and of the Federal reserve banks has, in the writer's opinion, never been sufficiently considered in detail. If a free system of transfers from one part of the country to the other is to be established, if balances with Federal reserve banks are quickly and easily to be created and used for the purpose of clearing, then all important cities must have branches and all minor cities must at least be within easy reach of a branch. It will be impossible to establish an effective system of transfers of balances with twelve zones, within the boundaries of each of which the easy transfer would remain confined. There are between sixty and seventy cities now that are entitled to branches, or where branches are necessary to cover certain sections. Let us take cities like Cincinnati, Cleveland, Toledo, Columbus, Indianapolis, Detroit, Milwaukee, Minneapolis, St. Paul, and Duluth. They would all be entitled to branches, and they might all be branches of Chicago. If we were to pick out one of these and make it a Federal reserve bank, the others, almost equal in importance or possibly superior, would fare poorly by becoming tributary to, and dependent on, an organization weaker than Chicago. But this must happen with twelve centers. Moreover, it is hard to imagine that a Federal reserve city should not become a central reserve city. To create twelve central reserve cities would defeat the very idea of central reserve cities—we need not enlarge upon that thought—but with twelve Federal reserve cities we could hardly escape that necessity. By adding San Francisco to the list of the existing three central reserve cities the question might be solved without difficulty with a system of four centers.[1]

If six centers must be created, we must suppose that New Orleans and some other city, presumably Boston, would have to be added. (But, again, the South, grouped around New

[1] With four Federal reserve banks one could imagine that each Federal reserve bank city would become a central reserve city; each city where there was a branch (and only those) would become a reserve city. If the accumulation of reserve money with reserve agents is to cease, the main motive in the determination of central reserve and reserve cities will have been eliminated. On the other hand, the position occupied by a city in the organization of the Federal reserve banks will become a very important factor, and inasmuch as there will be a certain concentration of business wherever there is a branch or a head office, it may be logical to require banks in these centers to contribute in a more substantial degree to the reserves of the nation than the other banks which in the future would constitute the "country banks."

Orleans, will be less efficiently provided for than by grouping a larger Southeast around St. Louis. Even New Orleans itself would fare better as an important branch than as a comparatively weak Federal reserve bank.) In other words —to use again our old metaphor, often employed in the last six years,—in order to procure fire protection for the entire community we must provide faucets in as many places as we possibly can(i. e., the branches), but we must concentrate the water so that we may have enough for any emergency. If we cannot concentrate all the water in one central reservoir, let us at least see to it that there shall be only a few and large ones. Small reservoirs will quickly run dry, thereby creating consternation, and any other small reservoir, that may be drawn upon, will quickly show the effect, again causing anxiety and, as a consequence, an increased demand. Large reservoirs can stand a drain without an alarming drop of the level and, if interconnected, they can assist one another without much sacrifice and without creating any convulsion or alarm. Twelve interconnected reservoirs would be a complicated system, inefficient in its results and to be handled only in the most arbitrary and haphazard way.

To insist on a large number of Federal reserve banks because, it is argued, reserves ought to be kept where they originate, is a selfish and narrow doctrine. For some charitable minds it may be a comfortable feeling of safety to see their neighbor's house burn down and to shut off from him their own water supply. But when their own house happens to be on fire they may find some fault with such a system. Moreover, with the key in the hands of a board appointed by the President, they should be able to overcome this provincial point of view.

As to the organization of the four Federal reserve banks and the Federal Reserve Board, it would not be difficult, while preserving machinery similar to that now proposed in the Owen-Glass Bill, to begin by organizing the branch boards, which would be responsible to, and under the control of, the boards of the Federal reserve banks. The latter would be constituted from members of the branches, and some members would be appointed by the Federal Reserve Board. Each branch would have a manager to be appointed by the board of the Federal reserve bank. Each Federal reserve bank would have a governor to be appointed by the President, from lists to be submitted to him by the board of the Federal reserve banks, which lists the President might return, asking for a new set of names. These governors would be first-class, expert men, who should receive large salaries in order to render them independent and in order to make the position an attractive one for men of the largest caliber. The Federal Reserve Board should consist of these four governors, three additional members to be appointed by the President, and to these should be added the governor-general to be appointed by the President in consultation with a committee consisting of delegates from the Federal reserve banks. It should not be difficult upon a basis of this kind to agree upon a constitution of the Federal Board satisfactory both to Congress and to the business community. The Secretary of the Treasury and the Comptroller of the Currency ought to be members of a board of supervision.

With units so large and a Federal Reserve Board thus constituted the powers of the latter may remain almost unchanged; but it is submitted that it may not be necessary to destroy the independent character of each Federal reserve bank by making it obligatory for them to rediscount for each other at the request of the Federal Board. If there be only four Federal reserve banks, the heads of which are members of the Federal Reserve Board, at which they would meet one another, they might be relied upon to stand by one another voluntarily —in particular if they have to deal jointly with government bonds, bank acceptances, foreign exchange, and note issue— and the law may be easily amended in case they should not.

In the writer's opinion Cabinet members should not be members of the active board. It would be safer both for these officers and for the country if men whom duty toward their party compels not to neglect the political aspect of each case should be kept away from this post. Moreover, Secretaries resign, or, in the course of events, they change, whereas it is most important that the members of the Federal Reserve Board should gradually become experts like the members of the Interstate Commerce Commission. There are no Cabinet members on this latter commission, nor are there any on the Supreme Court, with both of which the Federal Reserve Board has been compared. Inasmuch as the Democratic party appears to have set its mind on exclusive government control, the writer's proposition, as above outlined, bears fully in mind this prerequisite even though he may consider it extreme. The plan as here proposed would not allow a single member on the Federal Board not appointed by the President; but none the less it would gain the confidence of the business community and overcome its objections, because the four governors of the Federal reserve banks, who would be thoroughly familiar with actual banking and business conditions in their respective zones, would have an opportunity and duty to confer frequently with one another, and would have an important voice in the shaping of the policies of the Federal Reserve Board. The remaining three members would be free from any political pressure. The Democratic party's principles would have been fully respected, and yet grave dangers and defects would be avoided.

But, no matter what conclusion may be reached in this respect, and what form the Federal Board may take, the dangers and iniquities of government management would be materially reduced by the establishment of only four Federal reserve banks. The more the Federal Board is called upon to deal only with composite bodies—that is, a number of varied elements massed together—the more it is protected from political pressure. The local demand would address itself to the Federal reserve banks; the Federal Reserve Board at Washington would deal only with questions of policy, applying to groups that would be so large that the divergent interests of the various component parts would in themselves eliminate any provincial color, helping the Federal Board to deal with its problems without fear or favor, in an absolutely statesmanlike unbiased way.

A structure of this kind would have the advantage, as against the Monetary Commission Plan, that, while there would be among the four reserve banks one policy of expansion or of contraction, they could each adapt their rate to their own conditions, as against the uniform discount rate for all the country proposed in the Monetary Commission Plan. The Federal Board might even have power to permit a Federal reserve bank to establish a higher rate for a single branch, when it appeared necessary to curtail a particular over-expanding branch or community, without wanting to affect by a higher rate the entire zone of the Federal reserve bank.

A structure of four (or six) Federal reserve banks would offer the greatest advantage in dealing with the government 2 per cent bonds and the note issue. With both of these features the Owen-Glass Bill deals in a most unsatisfactory way.

In the first place, our currency is already redundant and we should begin with the existing maximum as the minimum, because national bank currency, based on government bonds, does not materially contract. We should provide for a possible increase of $500,000,000, though this limit has now been removed by law, but for a decrease of only $35,000,000 for the first year. The entire national bank currency ought to be converted into elastic currency from the beginning. What do we gain by spreading this conversion of bonds and notes over twenty years? There is every argument for a prompt conversion.

The present proposition is unsatisfactory for both the government and the banks. If we consider that within the last twenty years English, French, and German government bonds have gone down about 20 per cent, anybody would be a bold man who would dare to foretell at what price United States Government 3 per cent bonds will sell within the next twenty years. If the United States should embark upon any national enterprise entailing a material issue of bonds, the price certainly would go down. Should United States 3 per cent bonds sell below par, the national banks would, of course, not convert. The national bank note issue, in that case, would remain outstanding for twenty years, when the United States would have to sell a 3½ per cent or possibly a 4 per cent issue to take the place of the old 2 per cent bonds. The present proposition, then, gives the option to the national banks to convert in case the 3 per cent United States bonds sell above par, while, if they sell below, the United States will have to take the loss. This is a poor proposition for the government; on the other hand, it is the minimum that, in fairness, could be offered to the national banks.

The Aldrich Plan proceeded on correct lines in converting the 2 per cent bonds all at once and in assuming the entire national bank note issue. It went astray when it provided that these bonds were to be kept from the market for five years and were to be sold only at the rate of $50,000,000 per year after that period. This meant that the National Reserve Association, having assumed over $700,000,000 demand obligations, would have had its hands tied if it had been called upon to protect these liabilities—an unsound position.

The problem is not an easy one. If we imagine that after twenty years the national banks would have disposed of all their bonds to the public, we must expect that, on the other hand at the period there will be required at least the same amount of circulation as we have to-day (and more according to the increase in population). That means that Federal reserve currency will have been permanently substituted for national bank currency, let us say to the extent of $700,000,000 to $800,000,000. But currency cannot be issued without something having been given in return for it, which means again that, inasmuch as the Federal reserve banks would not own any government bonds against these outstanding notes, they must have other assets to that extent—that is, mainly, commercial paper. It follows that, in addition to their own capital and part of their deposits, the Federal reserve banks would have *permanently* invested about $800,000,000 in commercial paper, and to this we should then have to add the extraordinary and seasonal demands for which $500,000,000 were estimated to be issued, a total of about $1,300,000,000 to $1,500,000,000. This would not be a healthy condition, for *normally* the Federal reserve banks should not be so deeply in business; they should become such heavy investors in commercial paper only in times of active demand. It would therefore be desirable to find a way of investing several hundreds of millions of dollars otherwise than in commercial paper, provided that these assets were safe and quickly salable. It is from this point of view that the following suggestion is made.

Let the four Federal reserve banks jointly assume the national bank note issue and let them take over jointly, in proportion to their respective capitals, the 2 per cent government bonds. Let the government convert half of the amount so taken over into 3 per cent 20-year bonds, the other half into one-year 3 per cent Treasury notes of the United States. As long as their charters last the Federal reserve banks would jointly bind themselves, whenever these one-year notes matured, to buy at par the same amount of new one-year 3 per cent Treasury notes. The advantage of this plan is obvious. For the United States it is indifferent whether they issue a twenty-year bond or a one-year bond the renewal of which at par has been guaranteed for twenty years. But the position of the Federal reserve banks would be immensely strengthened thereby. For, in case the Federal reserve banks found themselves in a situation where they wanted to strengthen their position or create a balance in foreign countries, they could at once sell these short Treasury notes, if not on a 3 per cent basis, let us say even on a 6 per cent basis. In serious times the loss incurred would not weigh heavily, because money at home would then be in strong demand and bring more than that rate. By such a sale the price for the long-term government bonds would not be affected in anxious times, when these could be forced on the market only at great sacrifice and at the risk of tearing down the price of all other securities. On the other hand, these United States one-year Treasury notes—which might be issued so as to mature half in January and half in July—would be a quick asset, a most suitable investment for the Federal reserve banks. With $350,000,000 of such an investment it might be quite safe to preserve the holding of the remaining $350,000,000 in twenty-year bonds. If it is found that the available liquid means of the Federal reserve banks have to be permanently increased, it can safely be left in the hands of the Federal Board to dispose of them gradually in favorable times and in quantities that the market will readily absorb.

While the government, in following this suggestion, would continue to run the risk of having to renew the 3 per cent bonds at their maturity on possibly a 3½ or 4 per cent basis, it would, on the other hand, preserve its chance of securing the advantage of a sale of the 3 per cent bonds above par, in case the investment market should take a favorable turn. It would not grant a one-sided option. Furthermore, the profit on the circulation would from the beginning be received by the Federal reserve banks—that is to say by the government—and the earnings of these Federal reserve banks would show an ample margin over and above 5 per cent, the importance of which we have already emphasized.

This presupposes that sound council will prevail, and that, in the face of the emphatic protest coming from all parts of the country, the framers of the Owen-Glass Bill will ultimately abandon their intention of letting the government issue the new notes. One need not be a prophet in order to be able to foretell that this heresy will have the same fate as the 16 to 1 silver standard and the guarantee-of-deposits plan, and that after a few years people will wonder how they could ever have considered seriously so absolutely unsound a theory.

Though, as against its original form, Section 17[1] of the bill has been materially improved, it still remains a puzzle to the writer how, in practice and in theory, it will work out in any satisfactory way. Is there to be a uniform rate for the "advances" of these Federal reserve notes? Or will the government undertake to discriminate between various parts of the country? Is this rate to be different from the bank rate in the Federal reserve districts?

Neither the constituent banks nor the Federal reserve banks, when granting accommodations, can know whether the ultimate customers will use this book credit for the payment of book debits (that is, by check), or whether it will be employed to discharge debts that cannot be paid by checks, and whether, consequently, notes will be required. Notes that have been issued to-day may again be turned into book credits to-morrow. They are interchangeable, and, from the Federal reserve bank's point of view, they ought to be treated alike, both as deposit liabilities. To cut these functions in two, to attempt to let the book credit and the note—twin brothers—be born by two different mothers, is a most anomalous proceeding. But, we must ask how would it be possible at all for the Federal reserve banks to act boldly and comprehensively with their problems, if they cannot rely on being able to provide circulation as long as they are within the limits of the law concerning their cash reserves and collateral? While it is inconceivable that the Federal Board should ever

[1] Section 16 in the final Act.

refuse to grant an advance to a Federal reserve bank in sound condition, still this arbitrary power given to the Board would be a menace and an unnecessary source of weakness to the whole structure. Moreover, is it at all reasonable that a Federal reserve bank should not be in a position to figure what its investments in discounts will return? To illustrate: If a Federal reserve bank buys from the Sixth National Bank $100,000 of 60-day paper at 6 per cent, and the latter draws a check against this rediscount, the Federal reserve bank nets 6 per cent. If the Sixth National Bank, or its customer, should draw $100,000 in notes, and if the Federal Board should charge 6 per cent for "advances," the Federal reserve bank would not receive any return at all from the investment. Why punish the Federal reserve bank, and indirectly the people, for issuing a legitimate amount of circulation? If the Federal reserve bank's earnings above the 5 per cent dividend are well assured, the amount charged for the advances will be put from one pocket of the United States Government into the other.[1] If there should be any doubt as to this 5 per cent dividend, would it not stand to reason that the Federal reserve bank, if it had ample cash reserves, would rather pay out its lawful money than pay for the costly "advance" of Federal Reserve notes? This is, of course, the very last thing the government ought to encourage, but we can hardly see how this consequence can be escaped under the law as drawn at present.

But these "advances," when carefully analyzed, are nothing but a myth. Sooner or later, but within twenty years, under the Owen-Glass Bill, there will be outstanding $700,000,000 of Federal reserve notes (which will have re-

[1] As a question of revenue to the government a tax on note issue is superfluous when the excess earnings go to the government. If the tax is created for the purpose of acting as a sentimental check on over-expansion—unnecessary, because an effective one is being applied by the bank rates—it ought to be based on "*liabilities*" (comprising deposits and notes issued) and gold cover. But, in a country in which the deposit-and-check system is so highly developed, it would be impracticable to apply the brake on the note issue alone.

placed the national bank notes), and in addition such notes as may have to be issued to take care of extraordinary demands, together, let us say, between $1,000,000,000 and $1,200,000,000. Against these notes "which will be the obligation of the United States," the United States will have no assets of its own whatsoever. The Treasury balances, of about $100,000,000, are to serve for certain specified obligations of the government, and are neither available nor sufficient for the purpose of securing these Federal reserve notes. The government relies absolutely on the Federal reserve banks to pay these notes when presented. It has no money to advance to these Federal reserve banks and it has no money to pay for the Federal reserve notes when presented. As long as the note is in circulation, the government kindly grants the "advance"; as soon as the note is presented for payment, the Federal reserve banks have to cash it. In other words, if we thread our way through this bewildering maze, it is not the government that gives the advance, but the public which holds the notes that grants the credit. In other words, it is not the United States upon whom rests the primary obligation, but the Federal reserve banks. The United States are the guarantors of the notes, which the Treasury would be called upon to pay only after the Federal reserve banks are in default.

Why then not put it into a clear form? Why not let the Federal Board at Washington issue these notes—under the supervision of the Treasury—for the joint account and as the primary and joint obligation of the Federal banks, the United States, in consideration of the profits to be received and against collateral, as proposed in the Owen-Glass Bill, guaranteeing the notes? It is this the writer makes bold earnestly to recommend. The status of both the government and the Federal banks would thereby become clear.[1]

[1] The guarantee by the United States is not a necessity; the notes would be good enough without the same; but as a matter of expediency it would appear wise to follow this course.

Under the Owen-Glass Bill the Federal reserve banks set aside a gold reserve for notes which they have not issued and which do not appear as their liability. The United States Government, on the other hand, is to issue up to $1,200,000,000 of notes, and against these no gold cover would appear on their statement; but as a cover they would show only the indebtedness of the Federal reserve banks. There is not sufficient differentiation between contingent and direct liabilities and contingent and direct assets. The Federal reserve banks are asked to assume practically a direct obligation for a contingent liability, while the United States figure a contingent asset as a direct asset. The writer proposes to put direct assets and obligations into the same balance sheet, and the contingent assets into the same balance sheet with the contingent obligations.

This is not a question of bookkeeping only; it has a most vital bearing upon the question of direct responsibility or contingent responsibility in the management of the Federal reserve banks. If the United States issued the notes as its primary obligation, if the Federal Reserve Board fixed any interest rates for these advances, the government would establish a direct connection and direct responsibility which, as we have shown, it is most important to avoid. If the method suggested by the writer be followed, any political pressure addressed to Congress or to the executive for a lowering or raising of rates, a freer or less free supply of facilities, in any particular part of the country, would be promptly turned off by the statement that while the government undertakes the responsibility for supervision, for installing an efficient and honest management, it could not have any direct influence upon the business of the Federal Reserve Board or the Federal reserve banks.

It is the world's acknowledged theory and practice to keep the obligations of the central banks distinct from those of the government. It would lead too far to present a full argument showing the advantages of the semi-official central bank over a direct government organ. It may suffice here to refer to the gold loans granted in critical times by the Banque de France to the Bank of England, a transaction that in 1907 we should have been only too glad to bring about for the United States, but could not achieve because there were no modern American bills and no central organization. A semi-official organ can bring about a transaction of such kind, which would be hardly compatible with the dignity and the duties of a government. This is another reason for keeping the government in a "contingent position," but not in the first line of battle.

History has shown that the Banque de France survived when the government of France went to pieces; it remained unchanged whether France became an empire, a kingdom, or a republic. History has shown that by keeping the central banks and the governments seperate entities, they become mutual supports. The government is a customer of a central bank; at times its largest depositor, at times its heaviest borrower. The government's credit strengthens the central bank, the central bank strengthens the credit and power of the government. Where government credit and bank credit have been mixed up, the consequence has been to weaken both. Is the United States, under the presidency of a man of science, going to throw this universal experience to the wind? [1] The friends of the present administration, and any good citizen, for that matter, cannot too earnestly warn it not to insist on any extreme measure that would antagonize wide circles of business men and the very element through the agency of which alone the benefits of the law can accrue to the people of the United States. While technical parts of the measure will have to be amended as the country develops,

[1] We cannot dwell here upon the harm and danger that would follow the watering of the United States gold currency, which would militate against our securities and our "discount market."

it will prove the greatest curse for the nation if the fundamental structure should not become a permanent one. Extreme party policy now applied will bring extreme revision whenever the Democratic party should happen again to become the minority party; and the Federal reserve bank, instead of being a rock standing unmoved and unshaken by the waves of party strife, will become its very plaything, something to be avoided at all hazards. We cannot set business free by tieing it in turn to the chariot of every conquering party. Wise moderation alone will insure the safety and the continuity which are the basis of prosperity.

It is sincerely hoped that amendments on lines here submitted will be adopted. As the bill stands to-day it is vastly inferior to the plan ultimately submitted by the Monetary Commission. In its present form the Owen-Glass Bill is fraught with serious dangers, and it would not be able to bring about those remedies and benefits that the country is entitled to expect. The suggestions made in this article take into full account the political requirements of the problem.

A reduction of the number of Federal reserve banks from twelve to four would not violate any principle. The demand for government control would be carefully complied with, and the notes would remain "obligations of the United States," with the difference only that they would express what in essence they are under the law, and that interest charges for "advances" would be eliminated. In dealing with the 2 per cent government bonds as here proposed, no principle would be involved at all, but the practical importance of this change for the safety of the entire structure cannot be overestimated.

Amended on these lines, the writer feels confident that the law, though not ideal, will redound to the benefit of the nation and be a credit to the party under the auspices of which it was created. The writer deems it wise not to burden this article with a discussion of a number of questions of a more technical nature, preferring at this time to center attention on the main points at issue. He hopes that it may not be considered a presumption on his part, if, just returned from Europe, after an absence of several months, and out of touch with the general discussion now taking place upon the subject, he ventures to make these suggestions. But the active interest which he has taken in developing the ideas on the main lines of which legislation is now proposed may, he trusts, justify his effort to point out some pitfalls which may prove fatal and which can easily be avoided.

DECEMBER 5, 1913

XI

THE OWEN-GLASS BILL: SHOULD THERE BE FOUR OR EIGHT FEDERAL RESERVE BANKS?

THE amendments to the Owen-Glass Bill submitted by the two Senate committees show most satisfactory progress in many respects, and we may congratulate ourselves that complete agreements have been reached upon many fundamental questions. On two main points, however, the two committees still earnestly disagree; these are the number of the Federal reserve banks, and the control of their management. It is fortunate that in this part of the controversy each side is right and each side is wrong. For this situation carries in itself the possibility of a wise compromise.

Senator Hitchcock and his friends are to be congratulated on the sound stand they have taken on the question of the reduction of the Federal reserve banks to a maximum number of four. There is absolute unanimity among all students of the question that the establishment of a discount system, bringing about fluidity of credit and reserves, can best be secured by one central bank. The writer has gone to particular pains to gather the expressions of views of the most prominent men in Europe, among whom are the presidents of a number of European central banks, leading financiers and heads of the largest financial institutions of Europe. They all agree that one central bank would be the best means of developing a discount system. While a majority insist that this is the only way, a few concede that there is a possibility of developing a discount system with several central banks. But all agree that in that case there must be as few as possible and that they must be tied together in an effective way by a business management free from political influence. They also state that if Europe is to be counted upon as an investor in our future American discounts, it will be a prerequisite that there be a free market for such discounts at home. It is clear that unless the European investor can count on his ability to resell such discounts in case he should desire to do so, he would have to consider the purchase of American discounts as an undesirable lock-up of money. If Europe should hesitate to take our American paper freely, our discount system will lose 75 per cent of its beneficial power. That a discount market would develop with a system of eight Federal reserve banks is out of the question. I do not wish to tire the reader by repeating the arguments which I have already advanced in a previous article,[1] but I venture to append quotations from some of the letters of these European authorities.[2] I am giving only abstracts from these letters, omitting the strong arguments they contain for a central bank and against a note issue by the government, these two points having passed beyond the phase of further deliberation in the present controversy. These men, some of whom are at the head of institutions of the same character as those we are about to create here, state in unmistakable terms the grave dangers that would arise from political influence in the management of such banks, and it is on this question that Senator Hitchcock and his friends go astray, while the views expressed in this respect by Senator Owen and his colleagues cannot be too emphatically endorsed. We need not enlarge upon the consequences that would follow a government management of the branches. It might debase and corrupt our entire political life, if the fate of the management of the Federal reserve banks and their branches should become the plaything of politics. No matter how we safeguard the government management in the beginning, a nation that flirts with the recall of judges may

[1] Cf. p. 237, *supra*.

[2] The quotations appearing as an appendix in the original pamphlet are here omitted.

at any time break down safeguards that we may now impose, and all the offices, from that of director down to that of hall porter, may become the spoils of the conquering party. One need not emphasize what consequences this might entail for our political and business life.

In dealing with the question of whether there should be four or eight Federal reserve banks, we have to concede that in certain respects both sides are right.

From the point of view of securing a strong system and of safeguarding a possibility of developing effective discount markets, there should be only four. From the point of view represented by the Owen wing, that an intimate touch ought to be established between the management of each Federal reserve bank and the district which it represents, and that each district should be certain of receiving the fullest consideration it is entitled to, a system of eight Federal reserve banks would appear desirable. Furthermore, it is true that, if we pipe-lined all branches up to four points, a great many of these branches would be located far away from the points of concentration, that the machinery would, therefore, not respond quickly enough and that the sympathetic touch might be lost. The object to be achieved then is to secure the concentration into four units, strong and independent enough to stand on their own feet and to develop fluidity of reserves and a discount market of their own, without at the same time losing by such concentration the necessary touch with the constituent communities.

The writer has repeatedly expressed his belief that in preparing this law insufficient attention has been given to the question of the branches. It is at the branch office that the actual business will be done. Any favoritism or any unfair discrimination will express itself at the branches, where bills are handed in for discount. Sound judgment and business knowledge must be shown here, where alone the character of the bill can be scrutinized and understood. It is therefore most important that the boards of these branches be wisely constituted, and the law, to the mind of the writer, errs, when in this most important point it simply leaves discretionary power with the Federal Reserve Board and the Federal reserve banks. In the writer's opinion the law should not begin by prescribing the election of the Federal reserve *bank's* board, but it should begin by providing for the election of a board of each *branch*. Let the Organization Committee or the Secretary of the Treasury designate those 70 or 80 cities where branches are to be established, and provide that the member banks allotted to each branch elect their board on lines similar to those provided by the Owen-Glass Bill for the election of the boards of the Federal reserve banks. The writer would then suggest that Class "A" be elected by the member banks and that the representatives of these member banks on the board be permitted to be directors or even officers of member banks. They should have a slight majority in the board, while Classes "B" and "C" should be appointed by the government. Directors of Classes "B" and "C" would be elected from classes other than bankers; Classes "A" and "B" would constitute the discount committee, Class "C" would become the committee of supervision. The chairman of this committee of supervision would act as chairman of the board. We should in this way constitute a local board which would be representative of all classes, which would command the local knowledge necessary to deal with the local paper, and in which the government would secure a vote and absolute supervision.

The plan that I have in mind would then provide for the establishment of eight regional Federal reserve banks, each, let us assume, with about eight branches. But each regional reserve city, for its own local business, would have to be treated exactly like a branch, and therefore we should have, including the regional reserve city, up to nine organizations, or, let us say, nine branches in each region, being a total of about seventy-two points at which offices would be created. It is not necessary to start with the full number of these branches in each case, nor need it be limited to eight. However, I am inclined to think that there will not be much less than 72 when the whole organization has been mapped out and there will be many more as the country develops.[1]

Let us now assume that the law is amplified, so that a number of these branch banks (let us say up to nine) would, in forming one regional reserve bank, elect a board consisting of one member to be designated by each branch bank.[2] We should then have eight regional reserve banks, let us say at New Orleans, St. Louis, Chicago, Cincinnati, New York, Boston, San Francisco, and at some other far-western point, e. g., Denver.

I should now propose that in each case two regional reserve organizations be linked together into one district, so that New Orleans and St. Louis would form one district Federal reserve bank, with its head office in St. Louis. The Chicago and Cincinnati district Federal reserve bank would have its seat at Chicago. Boston and New York would together form a district Federal reserve bank at New York, and the Denver and San Francisco Federal reserve bank would probably have its seat at Denver.[3]

[1] While the suggestions here made appear to be radical they can be embodied into the law with comparatively few changes not disturbing the general lines of the bill. They follow the structure of the Banque de France and the Reichsbank, where there are local boards at the main branches. As the system develops, agencies or sub-agencies are established as feeders of the branches, or the number of the latter is increased. The Banque de France has now one head office, 128 branches with local boards and 71 auxiliary offices and 312 agencies, together 383, which are attached to the branches. The German Reichsbank has now one main bank at Berlin and 20 main branches with separate boards, in addition 76 branches and about 400 side branches.

[2] If there should be less than five branches, each branch might designate two members.

[3] If it were thought wise to have three regional reserve banks to cover the Pacific Coast, it could be done under this plan without interfering with its general structure. There might be three regional reserve banks, viz., one at

The boards of these district Federal reserve banks would be constituted of four members each, to be designated by each regional reserve bank, and to these would be added the governor and two deputy governors to be appointed by the President of the United States. They would be chosen from lists to be submitted to the President by the eight members of the board of the district Federal reserve bank, the President having the right to reject these lists entirely, asking for new names. If, after three lists had been submitted, the President and the district Federal reserve bank could not agree, the President would choose from one list to be submitted by the Federal Reserve Board. The governor would be in charge of the district Federal reserve bank, the two deputy governors would be placed in charge of the regional Federal reserve banks. The stock to which all the banks of the various branches subscribe would be that of the district Federal reserve bank.

If we review at this point the advantages that would be gained by a plan of this kind, it will become apparent:

First: The unit of each district is large enough to include varied forms of industrial, agricultural, and commercial interests, so that the district will be able in itself to comply more readily with the demands that may spring up from time to time.

Second: For transfers and collections, the boundary line within which these will move freely has been enlarged.

Third: The local character of the branch boards which will deal with each individual case has been preserved, but the character of the board of the district Federal reserve bank,

San Francisco, one at Seattle, and one at Denver or Salt Lake City. The three would have one stock capital, and each would designate one-third of the members to the district board, which would have its seat at the most centrally situated point,—probably Denver or Salt Lake City. Similarly, if at a later time it should be found advisable to divorce Pennsylvania and Maryland from New York, the New York district might be divided into three regions instead of two.

which will have to deal exclusively with larger problems of policy, from a higher point of view, without consideration of individual wishes, has been delocalized; it has lost its provincial character, all districts being represented.

Fourth: The four districts so created will be large enough to command confidence, and large enough to enable the development of discount markets. At the same time, the equality between all branches and between all regional banks has been preserved. For its local transactions the central point, i. e., New Orleans, would have a board, constituted exactly like that of a branch, e. g., Dallas. For its dealings with its branch banks, the regional of New Orleans would be in exactly the same position as that of St. Louis, and the district Federal reserve bank of St. Louis would be constituted from as many members of the New Orleans organization as that of St. Louis. Full consideration has therefore been given to the apprehension that by concentration the sympathetic touch, to be preserved for each region, might be weakened, and that the central points might gain at the expense of the minor points. An organization of the kind here proposed would remove the reason for any such fear, the parity among all eight cities having been strictly safeguarded.

Fifth: If the plan be carried out that a portion or all of the stock of the Federal reserve bank is to be owned by the public, it stands to reason that the latter would much rather buy the stock of a larger organization than that of a smaller one, because the smaller ones are apt to feel to a stronger degree any losses that might be incurred. Moreover, the market for the purchase and sale of these securities would be a more reliable one, if there were only four different kinds of stock, than if there were eight or ten.

Sixth: If at any time it should be found desirable to subdivide the districts into a larger number of regions, there would not be any difficulty in doing so under this plan, while the difficulty of reshaping the districts would be increased if stock of too many organizations had been sold.

It might be well to explain at this point what would be the functions of each of these three boards. The underlying principle of an organization as here proposed would be that each branch should be credited with the amount of the capital stock subscribed by its member banks and the aggregate amount of its deposits. On the other hand, each branch would be debited with the aggregate amount of its investments in commercial paper as well as its proportion of United States Government bonds taken over and the circulation taken out by the regional Federal reserve banks. Each branch once a week would give its status to the regional bank, which would consolidate all statements of the branches into one, showing the position of the regional bank. Each regional bank would then send the consolidated status and that of the individual branches to the district Federal reserve bank, and the latter would consolidate the statements of the regional banks into one, and send the same, with such additional information as might be required, to the Federal Reserve Board, which would publish regularly the consolidated and individual statements of the four district Federal reserve banks.

The regional board would apportion the funds among the branches, permitting, in its discretion, one branch, as a matter of bookkeeping, to draw on the funds of the others, or rather to go deeper into its own reserves, judging by the consolidated status of all its branches the extent to which each branch might be accommodated. In such deliberation it would be guided, of course, by the fact of whether or not such demands made by any branch were based upon seasonable and sound requirements. The district reserve board would, in turn, apportion in a similar way the funds between the two regionals, taking into full account the status of each regional and of its branches. It need hardly be repeated that fairness of dealing would be assured by having each regional board consist of members from each branch and by having the district board constituted by an equal number from both regionals.

The discussion just begun on the Senate floor has already shown the absolute necessity of dealing more explicitly with this question of branches. Atlanta desires to be made a Federal reserve city, because she objects to being forced to rediscount at New Orleans. If this claim should be granted there would be a great many cities, equal or more important in size and banking power, which would justly insist on the same privilege. The consequence would be that a large number of small and weak reserve districts would be created, a system which would be doomed beyond doubt. The plan as proposed by the writer would easily solve this problem in one of two ways: One method would be to subdivide the district into more than two *regions*, which could be done without weakening the power and basis of operation of the district. The other way would be to have Atlanta satisfied with a branch. If Atlanta understood that for her local business she would have a local, independent board, just the same as New Orleans, if she understood that the bills rediscounted at Atlanta would normally remain until maturity in the hands of the Atlanta branch, if she understood that in the regional board she had the same vote as New Orleans, and that for the running of the business of the regional it is as immaterial whether the board be located at Houston, Dallas, Atlanta, or New Orleans, as it will be immaterial whether the district board is located at St. Louis or New Orleans, she should and would be quite satisfied to become a branch.[1] The actual business would be

[1] A Federal reserve bank including all the national banks of both Atlanta and Savannah would have a capital (on the basis of 6 per cent of capital and surplus) of about $600,000 and deposits of $600,000 to $1,300,000. The Federal reserve bank, on a very liberal calculation, would then have resources of its own of less than $2,000,000. In normal times it might grant accommodations of $700,000, in strenuous times it might grant another $600,000. How long would it be till the Federal Reserve Bank of Atlanta would have given all the accommodation it could provide and would have to put its rates so high that any additional requirements would be satisfied from other quarters?

Would not Atlanta fare better and be more secure if she were part of a larger organization? The Atlanta rate would remain more stable and, as a matter of fact, Atlanta would be in a more dignified position.

done by the branches, and the administrative organizations at the regional and district points would have the same neutral composition wherever they happened to be located. As the bill is drawn at present, it is quite unclear how these branches are to be constituted and what powers they are to have. If they were to be only agencies, run by managers, who would discount bills subject to the approval of the Federal reserve bank and who would have to forward these bills to these head points, Atlanta's objection would be fully justified. Moreover, such a slow and cumbersome system would prevent the development of a free discount system which should make the sale of discounts as quick and as responsive as the calling of a demand stock-exchange loan. It is to be assumed, however, that the framers of the Owen-Glass Bill have in mind some system of this kind. If they have not, if they intend to give local boards to each branch, it would be advisable to state this clearly and to let the member banks of the district of the branch have a voice in selecting some of the directors whom they know and trust. This would be better than to have the entire local branch board appointed by the Federal reserve bank's board, on which there would probably be one single member only representing the district of the branch. Furthermore, as the Owen-Glass Bill is drawn at present, the anomaly would arise that any Federal reserve bank board would probably not have more than one single member who would be competent to pass on the local discounts of that Federal reserve city. To illustrate: The Federal Reserve Bank board of New York would probably be constituted of members from New York, Philadelphia, Pittsburgh, Baltimore, Washington, D. C., Buffalo, Rochester, and possibly Boston. This composite board, on which there would not be more than one New York member, would have to pass on all the New York paper to be discounted by the New York Federal Reserve Bank. This is, of course, a dangerous and impossible situation. There should be in New York a local committee or board, as there should be in Philadelphia, and the composite board should deal only with questions of general policy, direction, and supervision.

If the Federal reserve bank board or the Federal Reserve Board at Washington, or both together, should have the power to appoint all local boards or to pass exclusively on all purchases of discounts, there would be too much concentration of power in a small group of men—the very thing that this legislation is planned to avoid.

It is not from a desire to be critical, but from a wish to be helpful, that these defects have been pointed out at such length. The writer is convinced that unless this question of branches be considered with more care a satisfactory system will not be created. There will be either a scattering of reserves or there will be a well-grounded apprehension of too much concentration of power.

Whether there be four Federal reserve banks with each about sixteen branches, or four district reserve banks with two (or more) regionals, each with eight branches, is of smaller importance. The writer strongly believes that the latter system is the better, because it will create clearer statistics and, for the governor in charge, a problem easier to handle.

This question of eight or four Federal reserve banks will be easily understood if we translate it into military language. Should we be able effectively to maneuver eight armies, if we entirely disconnected them, not permitting them to communicate with one another or to come to one another's assistance, except by way of reporting to headquarters at Washington? Should we not have a better chance of success if above the generals in charge of each two of these armies we placed one leader, who had authority to detach reserves from one army and throw them to the assistance of the other, or throw both armies into one and divide them again, without costly and dangerous delay and long explanations which might be only half understood at headquarters? Would not the two armies feel safer and more certain of success? Would they not in fact be stronger than each standing alone? Again, would not the two army corps be better organized by having each an able general and one leader above them, than if the one leader were to manage alone the sixteen armies constituting the two army corps?

If the System is to succeed, the units by combination must be large enough to stand alone. If any one of them is so weak that it will frequently have to appeal to others, it will interfere with the others' safety and efficiency, because, no matter how well the others might keep their own house in order, they could not foretell what their own available resources might be the next day.

Moreover, if these units, though large, are to show a clear picture, which must be fully understood in all its details, if the local and the Washington managements are to be successful, then men and figures must be grouped. The figures must be clarified and simplified and they must crystallize in the brain of the man in charge at each point. The four governors heading the four district Federal reserve banks must rely for their information on the two deputy governors in charge of the regionals, as these in turn would depend on the managers of the branch banks. It is not only the larger financial strength that is an absolute prerequisite for an effective system; it is just as important to reduce the problem to so simple and clear a form, assembling men and material, that the Federal Reserve Board can intelligently and successfully deal with it.

It has been claimed that the Federal Reserve Board is not an administrative body, but merely a supervisory board. Nothing could be farther from the truth. If this system is to be crowned with success, the Federal Reserve Board must be an administrative board, and the larger the number of Federal reserve banks the more far-reaching would become the power and administrative duty of the Federal Reserve Board.

An effective discount policy, an effective gold and foreign exchange policy, and an effective method of dealing with the one-year Treasury notes and 3 per cent government bonds can be secured only by a strong and intelligent Federal Reserve Board. On the other hand, intelligence in all these very intricate questions can be displayed by the Federal Reserve Board only if it is in intimate touch with the conditions that exist, not at each point in this country alone, but also in each country of the entire globe. It is impossible for the seven or nine men, sitting in Washington in happy seclusion and far away from the business centers, to deal with these questions wisely, unless intimate touch with those centers be established where all these threads converge. It is true that in crystallizing the problems of the country up to four points the difficulties of the Federal Reserve Board will be materially reduced.

Instead of dealing with eight parts and instead of having the duty of equalizing reserves by helping one out of eight—and simultaneously of singling out one or more out of seven on whom to draw—the problem would be reduced to judging one case out of four and distributing the burden among the other three. It is even more important that this question of distribution (which with eight centers might easily become a question of retribution) come before the Board only rarely if at all. As to the problem of dealing with bank acceptances, foreign exchange, government bonds, and gold, it is much easier to bring about an understanding between four members from large units that have lost their provincial character, than between eight units, where each would have in mind only the advantage of its own little corner.

While the problem has thus been simplified, and while it is conceivable that of the seven or nine members of the Federal Reserve Board four might be delegated each to take particular charge of one of the four districts, the governor general and the other members of the Federal Reserve Board would still receive their information by an indirect and ineffective method. It would be infinitely better and would immeasurably strengthen the Federal Reserve Board, if the four governors of the four districts (who would have been appointed by the President) should actually become members of the Federal Reserve Board. These four governors would contribute and impart in a direct way to the other members of the Federal Reserve Board the actual business knowledge necessary to assure a wise management. At the same time a sorely needed opportunity would be given to these four heads of the four district banks to meet one another and to discuss with one another conditions as they exist in each district. This would enable them to form a clear judgment, not only of the conditions governing in their district, but also of those of the other districts, and thus help them to decide upon a wise policy to be pursued by the Federal Reserve Board, not only for the entire country, but also for each district. In this respect the bill as drawn at present is entirely defective, because it does not provide at all for an exchange of views between the heads of the various Federal reserve banks. They run along disconnected from one another, where they should understand and help one another.

The advisory board as planned will not fill the gap. The men on that board cannot possibly have the knowledge, nor speak with the authority of the heads in actual charge, whose main duty it would be to understand and to explain the conditions of their particular district. Moreover, if these four heads, who are responsible for the weal and woe of their district, should have a vote on those questions that so deeply touch their own fate, there would be more confidence in every part of the System that conclusions, no matter whom they might hurt, had been reached with full knowledge, for the best of the country, and without fear or favor.

I should suggest that the Federal Reserve Board be cut into two parts, the one—the discount committee, to consist of these four heads, together with the governor general and two deputy governors general, to be appointed by the President; the other—the committee of supervision, to consist of the Secretary of the Treasury and such other members as may be designated by the President. The discount committee would deal with all questions of routine and business; the board of supervision would be in charge of the supervision of the entire System. Both together would form the Federal Reserve Board, which would pass upon all questions of rules and regulations. The discount committee should be able to act only with the consent of the governor general or the acting deputy governor general, and in case of disagreement, the question would have to be brought before the full Board, where the Secretary of the Treasury would preside and would have the casting vote in case of a tie. The object of dividing the Board in this way will be apparent without much explanation: It takes the government official out of the embarrassing position of normally passing upon questions of business, for which the governor general, appointed by the President, would be mainly responsible, but it gives him supreme power in case of a tie. Furthermore, it gives him supervisory power—which should be primarily the government's function—over the entire System.

The plan as here proposed appears to the writer as a compromise which might be acceptable to both sides to the controversy. It preserves the larger number of the regional reserve banks and branches which insure local independence and local sympathetic understanding, but at the same time it combines eight disconnected and weak units into four larger and stronger ones, which will be necessary for the development of any effective discount system.

As far as governmental influence is concerned, the government secures supervision from top to bottom. It secures a management appointed by the government at the top and down to the middle, where the functions of the regional and district Federal reserve bank boards will be those of apportioning funds and of advising and deciding upon the rates at which accommodation should be granted. It leaves the majority at the branches in the hands of business men with a strong share in the management of men appointed by the government, with a strict supervision not only by the government, but also by the regional banks.

While the highest authorities of Europe, whose system, after all, we are copying, are practically a unit in stating that a perfect discount system can be established only through one single bank, I most confidently believe that—considering all the requirements of our case—we are safe and wise in starting with four units, provided they be properly organized and managed. But nothing will change my profound conviction that a system of eight Federal reserve banks, as now proposed, will end in failure. An effective discount rate is the link between the lever and the brake. Without an effective discount rate no European central bank would be able to stand. With eight independent districts (and even with six), no discount market can possibly develop. The safety of the System will be lacking, the member banks' funds will remain largely, as before, in the New York Stock Exchange. It seems scarcely justifiable to legislate the national banks into a position where they either would have to abandon their national bank charter and suffer a material loss on their 2 per cent government bonds, or where, as the only alternative, they would have to throw in their lot with a system that, if carefully administered, could bring only very little relief and, if managed without such extreme conservatism, would be bound to collapse. If the System be amended on lines as here proposed, objections against such constraint will largely be dispelled, and it may be expected that even a majority of the state banks and trust companies would join.

A management of great ability might, by its sagacity and impartiality in equalizing reserves, gradually diminish to a certain extent the only too natural apprehension and distrust of the banks. It might, in spite of the law—by encouraging meetings of the heads of the Federal reserve banks among themselves and with the Federal Reserve Board at Washington—bring about, to a certain degree at least, the much needed coöperation. But, as planned at present, the heads of the eight or ten Federal reserve banks would be so busy at home and half of them so far away, that frequent trips to Washington would be impossible. The plan of having *district* Federal reserve banks would cure this defect, because the trips would be cut in two and the absence from duty would thereby be reduced to a minimum. The San Francisco manager would once or twice a month go to Denver, where he would meet the head of the Denver and Seattle regional banks. The governor of the Pacific district, living at Denver, would once or twice a month go to Washington. Moreover, as the Denver governor's duties do not entail any large amount of detail routine work, he would have and should have the necessary time for extended conferences at Washington. But any wise management, no matter how hard it tried by administrative measures to overcome the defects of the present bill, would be forced to remain close to the shore. The rates would have to be kept high and changes would have to be made frequently in order to keep the district from getting overcrowded or from upsetting the stability of the other districts. The men in charge, both at Washington and at the Federal reserve bank points, would work under a serious handicap, which it would be cruel and reckless to inflict upon the nation.

It will take a few hours only to amend the bill on lines as here proposed; it will take weeks, and possibly months, of acrimonious debate if a proper basis for a compromise on these two questions cannot be found.

OCTOBER, 1913

XII

THE OWEN-GLASS BILL: GOLD OR LAWFUL MONEY, NOTE ISSUE, GOVERNMENT BONDS, AND SIMILAR QUESTIONS

THERE has been a rather lively discussion in the papers and in Washington upon the question whether Federal reserve notes should be paid by the Federal reserve banks in "gold" only or in "gold or lawful money," and furthermore, whether Federal reserve notes should be counted as reserves by member banks.

Let us first see what is lawful money. The answer is: gold dollars, silver dollars (not silver certificates), and greenbacks. Any greenback presented at the Treasury in Washington must be paid in gold. Moreover, as the United States has solemnly undertaken to keep all the various United States currencies at par, even silver certificates presented at Washington would, upon request, be exchanged for gold.

The amended Owen-Glass Bill provides that Federal reserve notes are to be paid in gold at the United States Treasury, and that the notes are to be the obligation of the United States. While it is correct that the United States must not be permitted to pay "one obligation by another," while the United States therefore must pay its notes in gold only, there is no reason why the Federal reserve banks should not redeem any obligation redeemable at their counters by paying in lawful money. If the Federal reserve banks were forced by law not to count lawful money as reserve and if they were forbidden to redeem Federal reserve notes in lawful money, it would mean that by legislative enactment they were obliged to discredit the sacred pledge of the United States. It would damage the credit of the United States and quite naturally lead to discrimination between the two kinds of notes which the United States has promised to pay in gold, a most illogical and unwarranted proceeding.

A similar argument must be applied in dealing with the Federal reserve notes as reserves of member banks. Reserves of national or state banks or trust companies have been created for the purpose of providing that these institutions should have available in currency at all times a certain proportion of their deposits, so as to enable them to pay off immediately upon demand substantial amounts of their demand obligations.

All debts are by law payable in lawful money and the Owen-Glass Bill provides specifically that Federal reserve notes be accepted in payment of all taxes and public dues except customs. Is it conceivable that a note which is the obligation of the United States payable at the Treasury in gold and which is receivable for all taxes and public dues as above, shall not be considered legal tender for any other purpose except the payment of taxes? Would Congress enact a law by which a bank or a private firm might refuse to accept in fulfillment of a contractual obligation a note issued by the United States payable in gold? As long as this note is to be the obligation of the United States let us at least be logical and bold about it and give to this currency the full recognition and privileges to which it is entitled.

If a national bank could not pay out Federal reserve notes to any other bank or depositor, how could we expect the member banks to give up their gold certificates and take Federal reserve notes instead? The strength of the future System will depend, however, upon the amount of gold that the Federal reserve banks are able to assemble in their vaults by substituting the new notes for the old United States currency now in circulation. But if national banks are to be permitted to pay their depositors in Federal reserve notes, why should such notes not be considered reserve money?

Moreover, if a balance with the Federal reserve bank is to be counted as cash by a national bank, how is it possible that a note should not be so counted? Notes could be turned into balances and balances into notes. How is it possible to discriminate between the two? At the close of business each national bank might send over to the Federal reserve bank or branch its Federal reserve notes and have them credited to its account, taking them back the next morning for use as till money. In that case the balance over night would count as reserve. If the bank happened to keep the notes over night in its own vaults, it is claimed that they should *not* be counted as reserve. Could anybody imagine any theory more confused and untenable?

In the writer's opinion, there cannot be any doubt whatsoever that the Hitchcock committee errs when it insists that Federal reserve notes presented for payment at the Federal reserve banks must be paid in gold alone. They ought to be payable in lawful money. Furthermore, it goes astray when it bars Federal reserve notes as legal reserve for member banks. Member banks are to observe only the commercial point of view of having a safe proportion of their deposits in cash balances or actual cash. Federal reserve banks are to maintain a safe proportion between their demand obligations and available lawful money. But it is the function and duty of the United States to provide for the fulfillment of its own promise at all times to pay in gold the notes issued by the United States and declared payable in gold.

The latest amendment by the Democratic caucus, creating a new circulating note to be the obligation of the Federal reserve banks and to be secured by the 2 per cent government bonds purchased from member banks, can be considered only as a most regrettable error of judgment. If, as has been claimed, the Federal reserve notes must be primarily an obligation of the United States, and the Federal reserve banks must not be permitted to issue the same as their own obligation to be guaranteed by the United States, and if, as has been stated in justification of this point of view, the people of the United States would not consider themselves safe except with a direct government note, how can we be expected to consider favorably this latest proposition? This circulating note of the Federal reserve banks is to be secured by government bonds—is not that a Federal reserve bank note secured by a guarantee of the United States?

There is only one difference, that the previous recommendations, which were declined, had in mind a note issued by the Federal reserve banks guaranteed by the United States, but covered by commercial paper, a certain amount of government bonds, *and an ample gold reserve; but all notes were to be an equal first lien on the assets of the Federal reserve banks.* The Democratic caucus now provides a 35 per cent gold cover and a first lien for the notes of the government, and expects the Federal reserve bank notes to be absorbed as second mortgage notes, apparently without an equal gold protection, while the old national bank notes—after the national banks have placed the bulk of their cash in the hands of the Federal reserve banks for the protection of the government notes—are to continue as third mortgage notes, until the last remnant of this unfortunate national bank circulation shall be redeemed thirty years after the passage of this law! That the Secretary of the Treasury is to be clothed with the power to permit national banks to count their own notes as reserve is another aberration which suggests the question whether a merchant would be kept out of jail if, by permission of the Secretary of the Treasury, in making up his balance sheet, he were to count his own promissory notes as quick assets.

The problem of dealing with the government bonds and the national bank circulation is a perplexing one, and we must, unfortunately, face the fact that for the next few years at least we shall have to be satisfied with some system which will not be quite free from theoretical and, to a certain extent, actual defects. But should we not try to create a system which will shorten as much as possible these years of transition and which, after that period, will become logical, sound, and simple?

Is it not clear that we must work toward *one* note issue? Think of the anomalous conditions that would arise if, on the one hand, the Federal reserve organization, by a liberal policy of note issue, should force the national bank notes to quick redemption and out of circulation and if, on the other hand, at times when the Federal reserve policy aimed at contraction of circulation, the national banks again began to put out their circulating notes. The note-issue policy must coöperate with the general discount policy, and both should be thrown into one hand as quickly as possible.

Sufficient consideration does not appear to have been given to the fact that when once the banks have thrown their reserves together with the Federal reserve banks—no matter whether the circulating notes are still being issued by the national banks individually—any obligation to redeem them in gold, in case of contraction or foreign demand, will fall upon the Federal reserve banks and incidentally on the United States, which for the redemption of its Federal reserve notes must rely on the strength and solvency of the Federal reserve banks. The Federal reserve banks, from the point of view of gold cover, will have to consider as their own obligations the national bank currency, whether or not they assume this burden from the start.

It would therefore be the wisest and safest plan to assume the national bank circulation as rapidly as possible, so that, as long as the responsibility rests with the Federal reserve banks, they will at least at the same time become the owners of the assets securing this circulation and, furthermore, that they may receive the benefit of the profits of this circulation, without which, it is to be feared, they will not have a sufficient earning power.

However, the taking over of all government bonds at once would alienate the country banks, which do not want to forego their note-issuing privilege so rapidly, and it would frighten a great many individuals, who are unable to perceive that the difference is only one of form. Moreover the formal status of the Federal reserve banks would be greatly weakened with respect to the gold cover to be provided against notes issued to them by the Federal Reserve Board against these purchases of 2 per cent government bonds. Let us assume as the first year's balance sheet the following statement, in millions:

Assets		*Liabilities*	
Discounts	$150	Capital paid in	$ 50
Cash	450	Deposits from banks	400
3 per cent gov't bonds	350	Treasury	150
3 per cent one-year Treas. notes	350	Notes	700
	$1,300		$1,300

This would mean a gold cover for notes of 64 per cent, and for liabilities of 36 per cent, which latter percentage would leave little room for a liberal increase of the note issue with which to supply the commercial requirements of the nation. If, however, we assume that within the next five years it would be possible to substitute $500,000,000 of new Federal reserve notes for lawful money in circulation the balance sheet would look as follows:

Discounts	$150	Capital	$ 50
Cash	950	Deposits	400
3 per cent gov't bonds	350	Treasury	150
3 per cent one-year Treas. notes	350	Notes	1,200
	$1,800		$1,800

This would show a gold cover for notes of almost 80 per cent and for liabilities of about 55 per cent and would leave a high margin of safety for the accommodation of the member banks and for the status of the Federal reserve banks. The further this substitution of Federal reserve notes for lawful money circulation proceeded the stronger would become the Federal reserve banks and with that the position of the United States.

It follows, then: First, there must be only one kind of notes, which must be eagerly accepted by the people and the member banks. The Federal reserve note must therefore have all legal-tender qualities, except payment for customs, and must be counted as reserve money by the member banks. Otherwise the free substitution of new notes for old will be interfered with. Second, as rapidly as this substitution proceeds, the Federal reserve banks, with the approval of the Federal Reserve Board and the Secretary of the Treasury, ought to be permitted to increase the purchase and conversion of the 2 per cent government bonds.

How quickly this process can be carried on, nobody is in a position to foretell to-day. It would therefore be a mistake to attempt now to lay down a hard and fast program for the future. The law should be so framed as to give ample latitude in this respect to the men to be placed in charge, who should be able to meet conditions as they arise.

I should suggest that the law be amended so as to provide that the Federal Reserve Board purchase from the member banks no less than 5 per cent annually of the aggregate face value of the 2 per cent United States Government bonds outstanding as a basis for national bank circulation at the time of the passing of the law, but that the national banks be required to turn over annually up to 10 per cent of said aggregate amount, in case the Federal Reserve Board, with the approval of the Secretary of the Treasury, should decide to purchase up to that quota. It should furthermore provide that additional amounts may be purchased in the open market, in case the Federal Reserve Board, with the approval of the Secretary of the Treasury, should think this advisable. If this method be applied, the national bank circulation could be eliminated within ten years, provided the status of the Federal reserve banks permitted.

As the acquisition of the 2 per cent bonds proceeded, the Federal reserve banks would convert the same half and half into United States Government 3 per cent twenty-year bonds, and one-year United States Treasury notes, to be renewed annually as provided in the bill. The Federal Reserve Board, with the approval of the Secretary of the Treasury, should have full power to dispose of the twenty-year 3 per cent government bonds. They might find it desirable to retain the bulk of these bonds. If, however, for the permanent strengthening of the status of the Federal reserve banks, it should be advisable to dispose of a portion of the bonds, the management can be trusted to do so in the best manner, adapting itself to conditions as they exist from time to time. No legislative body can foresee now what these conditions will be. The one-year notes would normally be held in the treasury of the Federal reserve banks and form there a most valuable means of combating emergency situations as they might arise. They should be the free property of the Federal reserve banks, and the Federal Reserve Board should have full power to deal with them.

It should be the object of this law to secure under strict governmental supervision the best possible board and the most efficient management, and to lay down the broad rules upon which the future institution is to be run. But no warning can be too emphatic not to attempt to legislate too strictly concerning questions of administration. I believe it is a fair statement that there is not a single member in either House of Congress who would feel qualified to undertake the management of this future institution. How then can they be expected to prescribe in the law details of administration whose effect cannot now be foreseen?

This refers not only to the question of government bonds, but to the question of discounting. The general principle ought to be that—as in the majority of the European central banks—normally no paper should be bought having more than ninety days to run. Inasmuch as the law as drawn at present contains an emergency clause which would enable the Board to purchase all kinds of obligations of the banks in case of need, it appears quite unnecessary to provide, as proposed in the Hitchcock amendment, that bills having a maturity up to 180 days and not to exceed $200,000 might be bought from each member bank. This clause looks petty and small, and would not warrant the breaking down of an important principle. In a similar way the Hitchcock amendment goes astray when it fixes a minimum amount that any bank at any time may require the Federal reserve banks to rediscount for it, and when it determines *now* the increase in rates for any additional rediscounts the member bank might require. The Federal reserve banks' management must be trusted to be fair and reasonable; it would be unwise to place it in a position where it could be dictated to or where it would have to be acting against its better judgment. Instead of laying down iron-clad laws, it might be better to insert a broader clause which would permit the Federal Reserve Board from time to time to establish rules, permitting or requiring the Federal reserve banks to charge a higher rate than the regular bank rate published, when member banks ask for rediscounts in excess of certain limits to be fixed by the Federal Reserve Board. This would give the Federal reserve banks and the Federal Reserve Board a means of protecting themselves, in case they found it necessary, but it would not bind their hands unnecessarily as long as a healthy supply of legitimate bills was offered for rediscount.

In closing, the question of the ownership of stock of the Federal reserve banks might be touched upon. This ought to be dealt with from a similar point of view. It might prove a good basis for a compromise if the member banks, which are to be required to subscribe to the stock, were to be permitted, after three years and with the approval of the Federal Reserve Board and the Secretary of the Treasury, to sell all or a certain portion of their stock holdings, provided, however, that each bank remained responsible to its Federal reserve bank for the liability following the stock certificate. If this plan were adopted the public would not now be asked to subscribe to stock which during the first few years might conceivably not earn its full dividend. The banks, on the other hand, would not be required indefinitely to tie up their own resources, which part of the scheme appears to be most objectionable to them.

It is not the desire of the writer to go further into a discussion in detail of the various sections of the law, but rather to confine himself to the above remarks, concerning a few of the main points. However, he ventures to hope that his arguments may have convinced the reader that the amendments, as proposed by the two Senate committees, cannot, by any means, lay claim to being considered as final and definite conclusions. Further careful deliberation will be necessary if the law is to become as perfect as the nation may justly expect. Much as speedy legislation must be desired by everybody, the problem appears to demand further open-minded discussion by calm and intelligent brains. Rather than to drive it roughshod to a quick conclusion, as a party measure upon which the final word has already been spoken, it would seem that the shorter and, in the long run, the better way would be for both sides to give and take and to agree upon the middle course, for safety lies between the cliffs.

PART TWO

SERIES A

OCTOBER 22, 1915

XIII

ADDRESS BEFORE THE MEMBERS OF THE TWIN CITY BANKERS' CLUB, ST. PAUL, MINN.

IN these times, when we are so deeply stirred and bewildered by the unhappy fate that has overtaken Europe, when it is so hard and well-nigh impossible to understand the path along which man is progressing, nothing will help us more toward finding our bearings than the study of ancient history. The more fully we understand that, for thousands of years, human problems have remained fundamentally the same, the more nearly we succeed in attaining a judicial and sympathetic understanding of the tragic struggle of our race. Human problems and human nature, indeed, do not appear to have changed since the time of Themistocles' speech on "national preparedness," delivered 2,400 years ago, of which Plutarch tells us, urging the building of a strong navy, or since his confidential message to the Persian King, Xerxes, informing him, after the battle of Salamis, that the "allies" were going to attack the Dardanelles. We are told that this message caused Xerxes to evacuate Greece in order to rush back for the protection of his bridge across the Hellespont.

When reading a sketch of the life of Lucullus, I was surprised to find myself suddenly thinking of the Federal Reserve Act. Lucullus had been sent to Egypt, Libya, and Crete. Plutarch tells us:

> He also made Cyrene, and finding it in confusion . . . he restored it to order, and fixed its constitution. . . . They asked him, it would seem, to write laws for them, and to mold their people into some form of sound government, whereupon he said *that it was hard to be a lawgiver for them when they were having such good fortune. In fact, nothing is*

> *more ungovernable than a man reputed to be prosperous; and, on the other hand, nothing is more receptive of authority than a man who is humbled by misfortune.*

So, you see, even in those days they required a 1907 in order to be ready for some sound legislation.

The following evening I took up the life of Camillus, and came upon this incident:

After a protracted siege, Camillus had taken the City of Veii. He had vowed that, if he should take the city he would consecrate the tenth part of the booty to the Delphian god. But, after the city had been taken, he apparently forgot his vow. At a later time, however, he referred the matter to the Senate, and, the seers announcing that the gods were angry, the Senate voted that every soldier, under oath, should return one-tenth of his share.

> The soldiers were filled with indignation. . . . However, all of them brought in the necessary portion, and it was decided to make a bowl of massive gold and send it to Delphi. *Now, there was a scarcity of gold in the city, and the magistrates knew not whence it could be had.* So the women, of their own accord, determined to give the gold ornaments which they wore upon their persons for the offering, and these amounted to eight talents' weight. The women were fittingly rewarded by the Senate, which voted that thereafter, when women died, a suitable eulogy should be spoken over them, as over men. For it was not customary before that time, when a woman died, that a public encomium should be pronounced.

When I read this chapter it struck me that the "votes for women" movement was already showing strength in the year 376 B.C. The Romans, however, were by far shrewder than the men of our generation, inasmuch as they at least secured a good and valid consideration for what they conceded.

The next thought that came to me in connection with this story was that even the question of the "gold reserve" is not modern, but that 2,000 years ago the same problem, how to withdraw gold from circulation and use it for the general good, confronted our forefathers. Seriously speaking, the incident cannot but remind us of the gold now being given up to the Banque de France and the Reichsbank by the people of France and Germany.

Like Lucullus in Cyrene, the advent of the Federal Reserve System came at a time of acute adversity. Its operation, however, had so excellent an effect and the resulting changes were developed with such speed that many are now forgetful of its benefits. When, some months ago, we were near the brink of a most serious international complication, few people stopped to consider the fact that we were not then subjected, through fear of panic, to any convulsions, such as we should inevitably have experienced before the establishment of the Federal reserve banks. I shall not tire you by enumerating the benefits of the System. I believe that those who think already know them; while those who do not think will learn to know them from actual experience. That will be conspicuously the case when excess reserves are next reduced and when higher rates for money again prevail.

I could wish, for many reasons, that it might have been possible to open the Federal reserve banks before the War began and that *they* might have furnished the $380,000,000 of notes that were issued under the Aldrich-Vreeland Act, as amended by the Federal Reserve Act.

The functions of Federal reserve banks in general and our present policy would then be better understood and there would be less talk about our earning capacity and the necessity of preserving the prestige of our Federal reserve banks by earning dividends. Had the Federal reserve banks been in operation when the War began and had *they* issued all the currency required last autumn, the rediscounts underlying these notes, at 5 per cent interest, would have produced a return of about $4,500,000, or about the sum required to cover running expenses and dividends of all Federal reserve banks for a year.

If the Federal reserve banks had put out this circulation and secured this return, would anyone suggest at this time that our banks should now make efforts to employ their money? Would not everyone agree that this present period of excessive ease of money was the proper moment for the reserve banks to withdraw their reserve money from active employment?

Earning capacity must never be considered the test of the efficiency of Federal reserve banks. Personally, I should have felt heartily ashamed had all our banks, considering the circumstances under which they began operations, earned their dividends in the past year. Such an earning, with all it implied, would have been a proof that they had completely misunderstood their proper functions and obligations.

It must be conceded, however, that only men who have been trained in banking or who have given close study to the question will fully understand that failure to earn dividends does not mean the impairment of the prestige of a Federal reserve bank as it would that of a member bank. It cannot, moreover, be denied that the banking instincts of those in charge of the banks will always remain—if only subconsciously—sensitive on this score.

For these reasons, it may well prove advisable to reduce the proportion of the paid-in capital of the Federal reserve banks so as to reduce, as far as possible, the conscious and subconscious pressure to force the funds of Federal reserve banks into actual employment at times when these funds should properly be withdrawn or held idle. Unless in times of great ease of money, Federal reserve banks withdraw the bulk of their money from actual employment, they cannot possibly be prepared to have their funds available at the turn of the tide when their beneficial powers should make themselves felt.

It is apparent, therefore, that the smaller we can consistently make the dividend requirements and the operating expenses of the Federal reserve banks, the better protected the System will be in time of trial.

But, on the other hand, we dare not consider the item of expense when it involves questions of safety. One of the heavy items of expense, for instance, is that of printing Federal reserve notes. A large supply of such notes, ready whenever required, is, however, a most fundamental safeguard, and the steady issue of Federal reserve notes resulting in an accumulation of gold and gold certificates in the hands of Federal reserve agents will form an important element of strength in times of need.

The Federal reserve banks have now in the hands of Federal reserve agents some $135,000,000 of gold and lawful money which, in case of a growing demand for rediscount by the member banks, may be freed by a process of redemption and substitution of commercial paper. This gold may be turned, as a free asset, into the vaults of the Federal reserve banks and may thus form the basis for an additional note issue of $200,000,000. It has been claimed by some of our critics that this process spells inflation. Nothing could be more unwarranted than such assertion. As long as there are deposited with the Federal reserve agents ten dollars of gold for each ten dollars issued in Federal reserve notes there is neither inflation nor contraction, but simply a substitution of one gold certificate for another. But the beneficial effect will be shown when demand will spring up for additional circulation, when, as a result, this demand will be satisfied, not by paying out currency which may serve as reserve, but by issuing the Federal reserve note which has been created for this very purpose. This process ought to be furthered by all member banks and even nonmember banks, for it is being carried on for their own protection. There is no such thing as the interests of a Federal reserve bank as against the interests of member banks. As yet, I fear, this is not sufficiently understood. The Federal reserve bank is the member banks'; it is your bank, your fire engine, constructed for your greater protection. You have paid for it and you are operating it. We are to be considered as your fire marshals. It is our function to see to it that the machinery is in good order and that conditions are such that fires may not occur too easily or spread too fast and too far. But yours is the engine, and yours is the fire!!

It is to your interest that your engine should not become rusty or obsolete, but that it remain a well-oiled and efficient instrument. In other words, Federal reserve banks must remain active banks, operating in certain fields with a varying degree of intensity.

If they are to exercise effectually the functions for which they have been created, access to these fields of operations must be given them ungrudgingly. They cannot protect you unless they can secure for themselves the strategic position without which they cannot act as regulators warding off interest rates both too high and too low and creating for the entire country a basis for a healthy development on a safe and solid foundation.

It is to your interest to see the Federal reserve banks as strong as they possibly can be. It staggers the imagination to think what the future may have in store for the development of American banking. With Europe's foremost financial powers limited to their own field, with the United States turned into a creditor nation of all the world, the boundaries of the field that lies open for us are determined only by our own power of safe expansion. The scope of our banking facilities will ultimately be limited by the amount of gold that we can muster as the foundation of our banking and credit structure. Gold that is carried in the pockets of the people, gold that accumulates as excess reserves in the member banks' vaults, does not afford the maximum service that the country is entitled to expect. Excess balances and idle gold should accumulate in the Federal reserve banks. They should control not $300,000,000 of gold, as they do now, or $450,000,000, as they will after another year, but they should control a billion or two of gold. The stronger the Federal reserve banks become, the stronger will be the country and the greater its chance to fulfill with safety and efficiency the functions of a world banker. The basis of this development must be confidence. Unless the member banks are profoundly convinced that their balances are as safe with the Federal reserve banks as they are in their own vaults—besides being more useful and efficient there—and unless they are convinced that the Federal reserve banks will not abuse their vast resources for inflation of credit or for the purpose of aggressively competing with the member banks, the full growth of the System and with that the full growth of American banking cannot be attained.

I may say with confidence that both the Federal reserve banks and the Federal Reserve Board are fully alive to the duty and responsibility that rest upon them in this respect and that they will do their share of the work as they trust, not only the member banks, but those not now members, will do theirs.

Believing in the bankers' sense of public duty, and animated by the motive of creating the broadest possible foundation for the development of a strong and united banking system in the United States, the Board has gone to the utmost limits of liberality in determining conditions for the admission of state institutions. In order to achieve this aim, it found itself in the difficult position of having to concede to these state banks and trust companies conditions which, in certain respects, give them a distinct advantage over national bank members. It is the hope and aim of the Board to see the powers of national banks liberalized; yet, for the time being, it remains a fact that state institutions entering our System are at an advantage. Such of them as are strong and conservative may come in practically with all the powers now enjoyed by them, and, in addition, may leave the System if they do not like it. Still they hesitate. As Lucullus said, "In times of prosperity, it is hard to legislate," and Walter Bagehot, the British economist, expresses the same thought in slightly more modern language when he says: "Political economy is only an absorbing topic when a nation is, financially and industrially, uneasy."

Let me ask those of the state institutions that are proud of their independent standing, is it quite fair to let your neighbors pay for the expense of the fire department when, in case of fire, you know you will count on the benefits of the general protection and when, as a matter of fact, you enjoy every day the advantage of the greater security provided by your neighbors? Let me tell them, at the same time, that insurance companies are generally willing to take risks while applicants are young and conditions serene, but are not very eager to write new insurance when the "quake" is on. Let me ask you, too, is it conservative banking for state banks to reduce reserve requirements, as authorized by many State laws in consequence of the establishment of the Federal Reserve System, if the state banks do not enter the System? Should not state banks remaining outside the System, as a matter of prudence, continue to observe the old reserve requirements?

The thought is often expressed that "at the time of the next crisis the state banks will all come in." I think it may be safe to say that they will find that many will then come in *after* the next period of anxiety. This is not meant as a threat, but I am afraid it will be a physical impossibility to take them all in during such a period of stress. Examinations take time, and many state banks will not look as strong during a critical period as they may look to-day. Moreover, the Federal reserve banks will find it difficult, in fairness to their own members, then to burden themselves with banks that might add an element of weakness, remembering that, in times of sunshine and peace, such institutions had refused to contribute their share to the work of protecting the entire community.

And now, permit me to relate to you one last reminiscence from ancient history. Aristotle, in defining the elements of liberty, gives us this definition: "One element of liberty is:

to govern and in turn to be governed. The other is: to live according to one's inclinations." I do not think that any modern writer has ever given a more interesting or a more original definition of liberty. Liberty without restriction is anarchy; submission to restriction arbitrarily imposed produces a slavish surrender of human rights. Between the two lies true liberty which means the exercise of our own free will and powers within the limitations which, for the protection of our liberty, we have agreed to impose and enforce among ourselves.

Our Federal Reserve System is to be considered from this point of view. For your own safety and liberty you have created this law and created the necessary organization for its enforcement. You have elected your government, and appointed your directors and officers. Do not think now of these administrative organs as something imposed upon you by others, but only as something of your own creation. This system, permitting you "to govern and in turn to be governed," as Aristotle puts it, is an expression and a safeguard of liberty.

You create your own traffic laws and clothe the traffic policeman with authority. As long as we obey the law, we consider him a means of protection, and we resent him as a restraining influence—only when we exceed the speed limit. While the Federal Reserve System is in its early stages, there must, of necessity, be a great deal of regulatory work. But I sincerely hope that the writing of regulations will soon become an occasional or incidental function of the Federal Reserve Board, and that traffic rules in banking will have become no more unusual or irritating than the raising of the hand of the traffic policeman.

As for myself, I am not in accord with the school of thought that believes that government's sole function is to regulate. I believe that the function of government is not only to regulate but to construct, and I believe that I am expressing the feeling of my colleagues of the Federal Reserve Board and of the men in charge of the Federal reserve banks when I say that we are looking forward to the time when all our energies may be applied, not to regulation, but to helpful coöperation in the general work of construction.

MAY 24, 1915

XIV

"WHENCE AND WHITHER?"—THE FUTURE FINANCIAL COURSE OF AMERICAN NATIONS

Address Before the Pan American Financial Conference, Washington, D. C.

IT is a great honor to be permitted to speak before a conference including the eminent leaders of government, finance, and business of an entire continent. It must be confessed, however, that to address so distinguished an audience upon a topic as difficult as the future financial course of the nations of America is a task to be undertaken only with great diffidence and hesitation.

We meet here deeply impressed by the unparalleled struggle which involves all the leading European nations and conscious of the fact that we are witnessing the beginning of one of the most important transformations in the world's history.

We cannot at this time forecast whether the outcome of this struggle will be a drastic revision of the world's map or whether national lines will remain substantially unchanged. But we already know that the economic consequences of this unhappy strife will be far-reaching and will vitally affect the future economic development of our own hemisphere.

The object of this address is to attempt to crystallize some thoughts that must have come to all of us who have stood in awe and amazement watching the sudden outburst and rapid spread of this disastrous conflagration across the Atlantic.

Before presenting these thoughts to you, on behalf of the Federal Reserve Board, I beg to express the great satisfaction that my colleagues and I feel at being afforded this opportunity of discussing with you the problem confronting all of us at this momentous turn in our history.

In August, 1914, six European powers went to war. The anomalous consequence of this event was that all American nations were thrown into a condition of acute financial and commercial disturbance.

Would it have been possible to avoid so disastrous an effect upon nations not directly involved in this struggle and thousands of miles removed from the fields of battle? And, furthermore, by what means may we hope to prevent, in the future, the recurrence of such fatal conditions?

These questions are deserving of the most serious consideration by this conference. The problem affects us all. We have all, whether in the northern, central, or southern division of the Western Hemisphere, suffered together. It is of the most vital importance that, if at all possible, a proper remedy be found.

Our sufferings originated in disturbances of three kinds—of shipping, of trade, and of credit.

These three phases of our economic life are so closely interrelated that a breakdown of one immediately affects the other. A collapse of credit must interrupt trade and therefore shipping. On the other hand, disruption of shipping and trade necessarily disorganizes credit, crippling, as it does, the banking machinery which rests on the fulfilment of contracts, remittances, and payments based on commercial transactions.

When in the face of untoward events actual experience affords a definite standard by which to judge cause and effect, it seems easy and often gratuitous for the critic to state what steps should have been taken. Retrospect is easier than forecast! Still, it is only by such analysis that we may hope to avoid similar mistakes in the future.

Reviewing, then, last summer's events upon these assumptions, we may say that disruption of shipping, trade, and credit in the countries of this hemisphere might have been less disastrous if, instead of relying exclusively upon Europe for their shipping and credit facilities, the American nations had begun in time to develop and organize their own large resources.

It is not within the purview of this address to elaborate the most interesting and important question, what American nations might have done in the past or what they should do in the future in order to secure their own transportation facilities independent of those of others. Confining ourselves to the subject of credit and banking, we may say with confidence that had the United States enacted and put into operation three years ago its Federal Reserve System, not only could our country have weathered the storm without such far-reaching disturbances, but we should have been in a position to save our American sister republics much loss and inconvenience.

In order to make this point clear it may be profitable to summarize briefly lasts year's events as now a chapter of the world's financial history. When the War began England occupied a most advantageous strategic financial position. She had been acting as the banker of the entire world, particularly by her system of acceptance credits, thus financing a vast majority of transactions involving the importation and exportation of goods between nations. The Hindoo, the Chinaman, the Japanese, the Australian, the African from Cape Colony to Egypt, the Canadian, the South American, the citizens of the United States, and those of a large number of the European states, all had used the English credit market.

But when the War broke out all countries were suddenly called upon to pay their debts and to finance their trade from that time forward wherever they could do it to their best advantage. The consequence of this situation was that England found herself in the position of a creditor calling upon the entire world for the payment of debts due at a time when shipping and trade were disorganized. It was therefore impossible within the short time granted for such payment to liquidate obligations by the shipment of merchandise, even though it had been previously sold under contract. At the same time a British debt to foreign countries was shielded by a moratorium, so that the foreigner who happened to be in debt to England, yet unable to collect there any sums due him, found himself able to settle his own debts to that country only by buying sterling remittances at most exorbitant prices or by shipping actual gold. British stock exchanges had been closed, and even those foreign debtors who owned British securities or securities which normally found a market in England by the sale of which, therefore, they might have created balances with which to pay their debts, saw themselves debarred from using these assets for the liquidation of their obligations.

Every country was thrown into confusion. Not one remained sufficiently undisturbed to be able to help the others.

An English writer, now officially connected with the British exchequer, has written a very able and interesting book wherein he sums up the condition then created, as follows:

> London was so strong that it did not know how strong it was. Consequently, being a little flustered by the suddenness of the outbreak of the War, on a scale that mankind had never seen before, it made the mistake of asking its debtors to repay it, not the thousands of millions that it had lent in the form of permanent investment, but the comparatively trifling amount—perhaps one hundred and fifty or two hundred millions (pounds sterling)—that it had lent in the shape of bills of exchange drawn on it, and other forms of short credits. Thereby it put the rest of the economically civilized world, for the time being, into the bankruptcy court, and so, finding that none of its debtors could pay, it thought itself obliged to ask for time from its own creditors at home.[1]

It is not for us to criticize England for having acted in the premises from a merely selfish point of view. This may well have been her duty. Her vital interests were at stake, and in view of the great catastrophe which she had to face it was necessary that she should muster from all parts of the world, not only her military, but also her financial reserves. Nor is much to be gained by insisting, with the British authority

[1] Hartley Withers, *War and Lombard Street.*

already cited, that some of the drastic measures which England found it necessary to take, and even her moratorium, might have been avoided if, immediately upon the beginning of the disturbance, she had been adequately prepared to issue without hesitation an ample supply of emergency currency.

We must not blame England; we must blame ourselves for having carelessly placed ourselves in this economically dangerous position.

Without venturing to analyze the problems of other countries, we may say with reference to the United States that the responsibility for having been caught tied hand and foot, when the crash came, is in two respects our own. As already stated, we should have reorganized our financial system several years ago so as to keep our gold under our own effective control and so as to enable us to finance with our own resources our import and export transactions. We should, furthermore, have avoided borrowing abroad when we could have financed our requirements at home, even though foreign aid was had at a slight advantage in rate.

The chief lesson which all American nations will have to learn from last year's experience is that it is unwise for the world to place its financial dependence upon any single nation; and that those who can afford to do so, as for instance the United States, should from this time on adopt a policy of greater reliance upon their own resources. Those countries which cannot rely exclusively upon their own resources should adopt a policy of dividing the risks of financial dependence as evenly and widely as they possibly can.

Financial dependence expresses itself in two ways: First, in the short-term credit granted to individuals; and, second, in the long-term and corporate credit, particularly that granted to governments.

Dealing first with the problem of individual credits, the United States may be profoundly grateful that just at this time its new banking system has been established. The day of the opening of our Federal reserve banks marked the advent of our financial independence. We are now able to finance our own imports and exports by the use of American acceptances. More than that, we are in a position to finance the trade of other nations and to play, in this respect, the part of an international banker that has heretofore been played almost exclusively by England. While it is true that Germany and France, during the past generation, have begun to finance a large portion of their own trade by acceptances of their own banks, the bulk of the business has heretofore been handled by England. There is no doubt that, upon the establishment of peace, there will be a tendency on the part of many nations to emancipate themselves in this respect, and we may add with profound conviction that it is precisely in this field that the United States will be destined to play a most important rôle.

We realize, of course, that it will be an arduous task to procure for our American acceptances the same standing in world markets as is now enjoyed by the acceptances of nations that have been in the field for generations past. Their commercial and financial relations are well established and bankers in foreign countries are more familiar with the names of European than of American acceptors. Moreover, the avenues that lead toward European establishments for the sale or discount of acceptances are clearly mapped out and at present of readier access than the new paths leading toward those of the United States. It is difficult to change well-established banking habits. We are well aware, therefore, of the fact that it will be necessary for this country to render the utmost possible assistance in order to facilitate a development so eminently desirable for the future protection of these large continents. This can be done in several ways:

First, by the readiness of our banks and bankers to enter this new field in a spirit of liberality and patriotism. They must be thoroughly imbued with the thought that it is necessary for the financial independence of their country and for the security of our American sister republics that import and export transactions touching this country should in the future be financed by ourselves.

It may be opportune to point out in this connection that the Federal Reserve Act gives ample powers for the development of this business even though these powers may have to be still further enlarged. Member banks may accept and Federal reserve banks may discount bills arising out of transactions based upon the "importation or exportation" of goods. The Federal Reserve Board has been advised by its counsel that the words "importation" and "exportation," as used in this connection, need not be construed as confining these transactions to importations or exportations into or from the United States, but that these transactions may also cover shipments between foreign countries. We shall be in a position, therefore, to serve as bankers for our American sister republics, not only in their trade with us, but even in their trade with others.

In order to develop this new avenue of American banking we need not even draw upon the means heretofore employed for the financing of our own commerce. The United States has a gold stock amounting to the phenomenal sum of about $1,890,000,000, of which so far only $300,000,000 in round figures have been concentrated in the Federal reserve banks. The Federal reserve banks need only continue the process just begun of substituting Federal reserve notes for the gold and gold certificates now in circulation, in order to gain control of a vast additional financial power which now lies idle. We may confidently expect, therefore, to find ample means to handle this business by the simple process of perfecting our organization and assembling our idle gold.

But in order to compete successfully in foreign markets we must have not only banks and bankers of undoubted standing able and willing to undertake these acceptance transactions, but also discount rates that compare favorably with those of competing nations.

The fact that within a few months our banks have been able to accept in the aggregate an amount reported to be in excess of $120,000,000 permits the conclusion that we have begun on a proper basis and with success. But the test will come when peace shall have been restored and when we shall have to make special efforts to maintain and strengthen our position. It will then be one of the functions of the Federal reserve banks to assist in the establishment of discount rates for these acceptances low enough to render them effective in securing business.

There is one other signal service that Federal reserve banks can render in this respect: that is, to facilitate the quotation of so-called "forward discount rates." A bank in a foreign country, when buying a dollar acceptance, must be assured of the rate at which the bill will be discounted when it reaches our country. On this rate it will largely depend whether the foreign shipper will use his European or his American credit facilities. The Federal reserve banks are fully alive to the importance of this question, and I may state on behalf of some of the largest of these banks that they will be prepared to give the greatest possible assistance by adopting a liberal policy in quoting such forward discount rates, good for a certain date or for delivery upon the arrival of mail by a given steamer.

The Federal Reserve Board and the Federal reserve banks have not yet reached any conclusions as to the most efficient method of fixing and transmitting these rates; whether they should be announced locally only at the office of a Federal reserve bank or whether it would be helpful to cable them to the main banking centers in foreign countries. It is hoped that both our guests and our bankers will consider the matter and give us the benefit of their suggestions.

The Federal Reserve Act, for the first time since the establishment of our national banking system, enabled national banks to open branches in foreign countries. Important branches have already been opened and others are soon to follow. It is hoped that the law may be amended in the near future so as to facilitate still further the establishment of such branches. It is generally felt that these direct connections with foreign countries will tend toward the development of better knowlege and understanding of local conditions and problems and the greater intimacy necessary for the development of cordial and mutually satisfactory business relations.

The vast powers of the Federal reserve banks will enable them to play a most important part, and they will do all they can to assist in facilitating the growth of a truly American banking system ramifying throughout our entire hemisphere.

The policy thus outlined as applicable to individual transactions should also apply to corporate and government financing. It is a source of weakness when a nation depends too largely on one single or several closely interrelated foreign markets, no matter how attractive may be the terms upon which its obligations may be placed there. For, as experience has shown, such securities can be thrown back upon their makers at a time when it is least convenient. If, during a critical period, one single market or group of markets becomes unavailable, while obligations of a debtor country mature, or requirements must imperatively be met, the debtor country finds itself in a most precarious condition.

It is true that one country cannot prevent another from buying its securities, nor would it be advisable hermetically to seal one stock exchange against securities quoted on another for fear that a closing of the one might force the closing of the other. The advantage of free international interchange in times of peace is such that we must be willing to bear the disadvantages resulting therefrom in times of war. But every country, in order to be safe, must be prepared for such an eventuality. The financial structure of a country consists of three main parts—funded long-term securities and the organization for marketing them, viz., the stock exchange; individual short-term credits and the organization for marketing them, viz., the discount market and the deposit banks;

and, finally, the note-issuing reserve banks. Every country must be prepared in grave emergencies to see the first of these three organs crippled and the stock exchange closed, but there must be such provision that the business of the country shall in that case be carried on by the other two units. In that respect last August found us still unprepared. The fact that our stock-exchange loans became unavailable crippled us. Our Federal Reserve System has since been opened, our organization is now established, and any future catastrophe will find us well equipped.

There is no doubt, however, of the vulnerability of any country if too large a volume of its securities be held in one other country. It is certain that the United States will be in a safer condition if, in the future, when placing the securities to be issued for the development of our own properties, we rely to a larger extent than in the past upon our own markets. It is important to state this principle emphatically, even though for the next few years to come it is not likely that Europe will act as a large purchaser of our securities owing to the stupendous amount of bonds issued by the various European governments, the extraordinary inflation of currency existing in almost every part of Europe, and the appalling loss of property suffered by those countries. Indeed, it may well be expected that from now on the United States will not only have to rely largely upon its own resources for its internal development but that we shall be called upon to provide means for absorbing the securities previously placed in Europe but now returning to us. It is impossible to predict how far the death struggle now going on in Europe must proceed before an end is reached, and we cannot, therefore, form any estimate of the extent of the destruction of property and prosperity. But even at this juncture it must be apparent to every student of the problem that borrowing nations will have to husband their resources and move slowly in the further development of their capacities until the power of some of these warring nations to save shall have recuperated and European money shall again freely seek opportunities for investment abroad. Upon the degree to which destruction continues will depend the rôle we eventually shall have to play, not only with respect to our own affairs, but with respect to those of others. No doubt there will be a strong desire on the part of other countries, and particularly of the American nations, to ask of the bankers of the United States governmental and corporate credits. Some large foreign loans, aggregating more than $200,000,000, have been recently placed as a beginning. Our country will be prepared to render very substantial service in this respect. But we must bear in mind that in order to create a broad market for bonds of foreign nations it is not sufficient that our bankers alone be familiar with these countries. It is necessary that the investor, from his own knowledge, have confidence and a sympathetic understanding concerning the borrowing country's conditions. In other words, in order to open a wide market for foreign securities there must be intimate business relations with the countries which offer such securities for investment. The belief is often expressed that foreign loans create foreign business relations. This is true, but it can be said with equal force that foreign business relations are conducive to the conclusion of foreign loans. We may state with confidence that the United States will prove a strong market, growing in importance from year to year, for the loans of those foreign countries with which we entertain business relations.

Europe has done much in developing the northern, the central, and the southern parts of this hemisphere. European banks and bankers have been our staunch and loyal friends in the past. It would be unbecoming in us, and disloyal at the same time, were we to forget this or to attempt to profit from their misfortunes. But our own growth and development and the unhappy fate that has overcome Europe have combined to bring us to a momentous turning point in our economic history. Our own steadily increasing weight and Europe's relatively weakened condition mean that the New World must in the future lean less heavily on the Old.

I think I am justified in saying that there is no difference of conservative opinion that the United States does not aspire now to take the place of Europe's leading financial powers. Our own field of operation is still too vast to enable us or to render it even desirable for us to become the entire world's banker at this stage of our own development. But the safety of all countries—and we include England among their number—demands that if again the latter should find herself forced to call upon her debtors for instant payment, there should be at least one country strong and independent enough to shoulder a substantial portion of the burden.

The development of all American nations lies in the same direction, though there will be a difference in degree. It must be the aim of the United States from now on to move rapidly toward entire financial independence. It must be the aim of her sister republics so to divide the credits needed for their further development that the temporary breakdown of one creditor country will not seriously embarrass them. They will enjoy the greatest degree of safety in this respect if their creditor nations are geographically, politically, and economically separated from one another as far as possible, so that in case one should become involved the other may be expected to remain unaffected thereby. Though in normal times closely connected with Europe, the American continents ought to be so organized as to form a distinct and independent unit in times of emergency—a union whose transportation and credit systems will remain unbroken, even though all Europe should go to war.

An American union of this kind will prove of the greatest economic advantage to all nations concerned. If such a union be thought desirable, it must, however, be forged and riveted every day of the year. If it is to stand the test of time and stress, it must be a structure of gradual growth, carefully planned and consistently developed, and built upon a safe foundation.

NOVEMBER 23, 1915

XV

THE FEDERAL RESERVE SYSTEM AND THE BUSINESS MAN

Remarks made at Charlotte, North Carolina, at a Coöperative Dinner Given by the Mayor of the City

IT is an honor of which I am deeply sensible to be invited by your Mayor to be your guest to-night. The opportunity of meeting and addressing the leading men of the South and of seeing with my own eyes its progress and growth is to me the greatest privilege. Charlotte and Mecklenburg are names that strike a very sympathetic chord in the heart of one who was himself cradled only a few miles away from the place where Charlotte of Mecklenburg, the godmother of this beautiful city, was born. If, in spite of this, I felt hesitation in accepting your flattering invitation, it was for the reason that, owing to the many problems calling for continuous attention during this period of installation, I have conscientiously avoided making addresses except where I had to do so on official business.

However, when Colonel Thomas L. Kirkpatrick, your energetic Mayor, did me the honor of calling upon me and, together with the Secretary of the Navy and Senator Overman, threatened to declare an effective blockade upon me unless I complied with their wishes, and when even my plea that I could not possibly find the time to prepare a speech befitting this occasion failed to convince them, nothing was left but to throw up my hands and surrender. So I am here to-night, glad and grateful, indeed, to be with you, but praying your kind indulgence in listening to my hastily prepared remarks.

When I asked your Mayor to tell me what he wished me to discuss, he said: "Our men would like to hear about the work of the Federal Reserve Board. And they would like to hear it as business men from a business man and in business language." Now, this is not an easy task, for I am no longer a "business man," but a government official; though indeed a government official in charge of a business proposition. And right here you have a characteristic phase of the problems of the Federal Reserve Board. We must indeed be business men, thinking like business men and understanding the minds and the problems of business men, or we could not possibly succeed in our work. At the same time, however, we must bear in mind that we are administering a public trust and that, if we should apply the business man's point of view exclusively, we should make a dismal failure of our work. Ours is a business proposition freed from the main driving force of business, which is the selfish though legitimate desire of making profits. We must be business men, because we are charged with the supervision and, in certain phases, with the direction of business organizations. But we must also be like a supreme court, charged with the duty of impartially administering without fear or favor a law that has for its primary purpose the financial safety of the country and fair and equal service to all. Effectively to combine these two points of view is the difficult task of the Federal Reserve Board.

I do not wish to tire you by going into a detailed description of the work of the Federal reserve banks or the Federal Reserve Board—I do not believe that the human constitution lends itself to digesting such technical details after so excellent a dinner—and so I shall speak to you only about the broad principles and the main features involved.

You all know that our national, state, and savings banks report about eighteen and one-half billions of deposits against which there is held in vault about $1,600,000,000 in actual cash. If all depositors should at the same time seek to have their deposits paid in cash, their demands could not be satisfied and whenever, heretofore, depositors became thoroughly frightened, panics ensued, with the histories of which you are fully familiar. But a banking system that did not provide for the eventuality of such runs was criminally defective, and so the Federal Reserve System was created, which is in substance a coöperative banking organization. The member banks now united in this System have pooled a certain portion of their legal reserves and placed them in charge of the Federal reserve banks, which are to be administered so that they will be able to extend credit or furnish currency to member banks needing assistance. Instead of depending upon the insufficient cash supply kept in their own vaults, the member banks now rely upon the commanding strength of the joint reservoir, the power of which has been immeasurably enhanced by the privilege accorded to the Federal reserve banks of issuing Federal reserve notes against the deposit of certain well defined commercial or banking paper. The Federal reserve bank is the simple expression of the principle "In union there is strength." This coöperative principle has been carried into further effect by linking together the twelve Federal reserve banks into one strong organization. The link connecting these banks is the Federal Reserve Board which has the duty and power to regulate and direct the credit facilities to be extended by one district to the other.

We should, however, be committing a great mistake if we considered these emergency functions as the only ones to be exercised by the Federal reserve banks. In creating local markets for commercial paper and thereby making such commercial paper an asset of greater liquidity, the Federal reserve banks every day in the year render a most important service. The Federal reserve banks, in effecting this change, are destined to lessen the concentration of reserve money on the Stock Exchange of New York, heretofore the great call loan market of the United States. The preparedness of the

Federal reserve banks to buy commercial paper enables the member banks to invest more liberally in this paper and to consider it as their main secondary reserve instead of the balances heretofore kept with correspondents in the reserve and central reserve cities.

The member banks and the business men of the United States will thus derive the greatest benefits from the Federal Reserve System by, first, the safety from acute panics of the old familiar kind, and, second, the greater ability of the member banks to uninterruptedly extend legitimate commercial credit facilities at reasonable and fairly stable rates.

But I fear that those in charge of the Federal Reserve System will undergo the same experience as a good friend of mine, one of the best physicians of this country. He said to me that one of the greatest difficulties of his profession was that effective preventive work was not remunerated and—disregarding that phase of it—that it was not even realized by the patient. If by sound advice he kept him from falling sick, or by simple means removed a disturbance, the patient never realized what the doctor had done for him; he felt well and thought that it was his own constitution that was asserting itself. If, however, the patient, owing to poor advice or lack of attention, became the victim of an acute disturbance necessitating prolonged treatment and often painful and dangerous operations, the patient had a tangible proof of what the profession had actually done for him and cheerfully paid a large price for the poorer treatment without realizing what he might have avoided. The position of those in charge of the Federal Reserve System will be very similar to that of a good doctor. If we succeed in keeping the country free from acute disturbances; if panics and the exorbitant interest rates that used to accompany almost every crop-moving season become things of the past; if credit facilities are ample and available at fairly moderate and steady rates, the country will soon cease to appreciate why it is enjoying such good health, and the danger will be that, instead of being satisfied with the benefits which thus come to them in an indirect way, they will foolishly insist upon some additional advantages which are more obvious and which they can more readily grasp.

We need only look back for a little over a year to find a case in point. How many people are able to visualize the probable condition of our patient had he been without treatment by the Federal Reserve doctor?

I still remember very vividly that in the fall of 1914 bankers all over the country sent us messages of alarm stating that, in spite of the issue of almost $400,000,000 of emergency currency, banks were restricting credits and that maturing commercial paper could not be renewed. Rates remained high and gold withdrawals frightened a banking community which had not yet been welded together in effective protective organizations.

The Federal reserve banks were opened and the mere announcement of this fact brought about the most drastic change that was ever witnessed by any financial community. Banks lost their fright and began to loan freely again; the public took heart and within the most surprisingly short time conditions changed and scarcity of money and credit was turned into extreme abundance.

Of course, there were other driving forces working in the same direction, such as our unprecedented exports to Europe. But had it not been for the confident reliance created by the consciousness that there was now in existence a permanent and strong banking organization prepared to give relief—the process of recuperation would have been a vastly slower one and business could not have gained the headway it enjoys to-day. Without the Federal Reserve System, the $400,000,000 emergency currency could not have been redeemed within a year and the cotton crop could not have been financed so freely or at rates lower than the South had ever before seen.

As a member of the Federal Reserve Board, I must refrain from praising or criticizing the Anglo-French loan of $500,-000,000, but I want to impress upon your minds that, without the Federal Reserve System, our country could not have been in a position even to consider a loan transaction of this magnitude. It is the confidence in the safety of our banking system that enables our banks now to deal boldly and liberally with the problems of this country—even though I venture to say that half of the banks that went into the Anglo-French loan did not stop to consider what it was that had indirectly enabled them to do so.

Without the Federal Reserve System, American bankers' acceptances would not be used to-day for the financing of our own foreign trade, and for that of other countries, all over the world. With rapid strides we are approaching the position of world bankers.

But, the skeptic might say, all the Federal reserve banks together hold an aggregate amount of only thirteen millions in bankers' acceptances. Surely so small an amount does not mean the financing of the world's trade. Certainly not! But it is the ability and readiness of the Federal reserve banks to buy ten times that amount that engenders the eagerness of the other banks to buy these acceptances. They wish to secure for themselves an investment for which there is so strong and so reliable a purchaser, and as a result, the broadest possible market for these acceptances is developed, and they become welcome instruments for the financing of the world's trade—not on account of the large amounts that we have actually bought, but because of the large amounts that we are prepared and able to buy. Incidentally, the safest and most liquid form of investment known to the banking world has been added as an element of increased strength and safety to the assets of our banks.

It is hardly necessary for me to mention to you that a similar situation exists with respect to cotton loans. All the

Federal reserve banks together have put out only a little over three million dollars in direct cotton loans, and the last statement of the three southern Federal reserve banks shows an aggregate of all loans made by them of about $19,000,000. But you, gentlemen, know without my telling you what it has meant to the South that the Federal reserve banks *stood ready* to furnish at moderate rates many more millions of dollars. The effective preparedness of the Federal reserve banks and the rates at which they offered to do business were instrumental in bringing you ample and liberal credit facilities.

The Federal Reserve Board organized a cotton committee, on which I served under Mr. Harding as chairman. It is a pleasure for me to acknowledge publicly the debt of gratitude that the country owes him for his untiring work. He had "his head in cotton" all summer and I learned to admire his fairness, his loyalty, and the thoroughness and intelligence with which he studied and analyzed the situation. I have no doubt that the South is as proud of its representative on our Board as we are of him as our colleague.

This committee used whatever influence it could exert in three directions: it worked for diversification of crops, for better warehouse facilities, and for measures by which financial pressure should be removed at the time of the marketing of the crop.

My friend, the physician of whom I told you a moment ago, says it is much easier to cure an intelligent patient than a stupid one. The effective diversification of crops and the headway made in the question of warehousing are a great exhibition of the high intelligence and energy of the South, and particularly of this section of the South.

If the root of our strength and of our usefulness is preparedness, it is evident that our preparedness must be real and that everything must be avoided that might weaken it. In other words, the vast resources of the Federal Reserve System must be actually ready and available.

Only in this way can we secure for the country not only the great indirect advantages upon which I have just touched, but the beneficial effects which accrue from direct action. The Federal reserve banks must be prepared to meet, by direct action, two kinds of emergencies—the regular and the sporadic. The regular or recurring comes into being whenever, through seasonal demands or generally increased activity, there arises a temporary demand for credit facilities in excess of what could readily be satisfied from the available means of the banks of the country. In such cases in the past excessive rates had to be applied in order to force liquidation and bring about a readjustment.

It is in meeting these seasonal and temporary extraordinary demands that the Federal reserve banks will render actual and most valuable service. When the banks of the country reach the end of their lending power or when, in order not to reach it, they would have to increase their rates—though the demand for credit facilities may be expected to be a healthy, seasonal one of a temporary character—then the lending power of the Federal reserve bank must be freely drawn upon and violent fluctuations must be and will be avoided.

The sporadic emergency, if I may call it thus, arises in the period of political, economic, or financial disturbances which may be caused by a reaction from other countries or find its origin in our own conditions. For, Federal Reserve System or no Federal Reserve System, critical times will occur, though in milder and more controllable forms, whenever men abandon the path of prudence and safety. No doctor's art can prevent the evil and inevitable consequences of excess and debauch.

When these critical conditions arise, they express themselves primarily in a strong demand for gold. It is in these periods, which, in the past, have played havoc with our financial organization, that the Federal Reserve System must show its protective powers. Great protection, of course, is derived from the fact that a large portion of our gold has now been concentrated in several large reservoirs, interconnected with one another, instead of being scattered about, as in the past, amongst many thousand small and unimportant units. Great protection, furthermore, is derived from the fact that additional currency can now be issued against the deposit of commercial paper. But, of course, if this issue of currency is to remain on a sound basis, the total volume of such currency and the aggregate of the liabilities of Federal reserve banks must not exceed a certain safe proportion of the gold actually held for the protection of these obligations. This limit must be preserved, and, therefore, the maximum degree up to which the Federal Reserve System will be able to render assistance will depend upon the maximum amount of gold that it can bring under its effectual control. At present the Federal reserve banks hold as a free asset, roughly speaking, $300,000,000 of gold. While this is a very large amount, we must not overlook the staggering size of the entire credit structure of the country, which amounts to approximately eighteen and one-half billion dollars. We must bear in mind the gigantic amounts in which international trade balances nowadays express themselves when the normal media of exchange and settlement are temporarily abandoned. We need only think of conditions such as we had to face when the European War broke out, when Europe presented to us a demand for gold amounting to about $400,000,000. We need only consider, on the other hand, the precarious state into which the European powers were thrown when, afterwards, these conditions were reversed. We must not forget that at present there is in Europe the greatest inflation of circulation and credit that ever existed in the Old World, and that, when the War is over, we may naturally expect a most determined and necessary effort on the part of all these powerful countries to secure a sufficient supply of gold necessary to give their credit structure a fairly sound foundation.

Nobody can foretell with any degree of certainty what reaction the end of the War may bring to us. But we do know that the higher our inverted pyramid of loans and deposits grows the more unstable a structure will it prove to be and the more essential it is, therefore, to fortify its foundation of gold.

I do not wish to tire you by a discussion of technical details, but I want to impress upon you only one of the important principles involved: Federal reserve banks must at times refuse to move in the same direction as—in fact, must move in the opposite direction from—the general banks of the country. That is to say, when the rank and file of the banks begin to hesitate and restrict, the Federal reserve banks must be ready to loan, and conversely, when the general banks of the country, in times of great ease of money, are most anxious to increase their loans, Federal reserve banks must retire their funds from active employment and accumulate idle money, inasmuch as only in times of ease can they carry out this latter process, necessary in order to secure a strategic position enabling them to operate again when the public interest will require.

Abnormally low rates of interest are a source of national danger. It is the time of excessively low interest rates that breeds a panic. It would lead me too far were I to dwell upon this well recognized fact. It is apparent to everybody that in order to earn a given amount, a bank must put out twice the volume of money at 2 per cent that it would have to put out if it could loan its money at 4 per cent. The cumulative effect of this fact is that the banks of the entire country are apt, in periods of excessive ease of money, to over-extend, and, because the return from normal and safe loans in such times is too low, they are likely in the end to make poor loans and to employ their money in fixed investments, which, undertaken during a period of high prices, such as usually accompanies low money rates, will lead to losses and to a lock-up of funds when the tide turns. And after a period of overstimulation of commerce and trade, fostered by a period of too easy credit, the tide must inevitably turn; and the greater the extreme to which low rates had gone, the greater must be the force of the reaction upon the turn of the tide.

It must, therefore, be the aim and the duty of the Federal reserve banks to counteract violent fluctuations of interest rates and to keep them as closely as possible to normal; they must freely use their lending power when rates rise beyond fair and healthy levels, but withdraw their funds and arrest, if they can, a movement which would lead to excessively low rates such as would be apt to bring about a dangerous reaction.

The country is best served if there is a steady and ample flow of credit at normal and moderate rates. On such a basis, trade and industry will thrive with the greatest safety and with the most lasting success.

As stated before, if you want the Federal reserve banks to exercise these functions, they must be in a condition of strength and preparedness. They must be able to marshal their funds at a given moment like an army which can be mobilized and thrown wherever it is wanted. And that is why the law has wisely laid down certain well-defined limits which must be observed in investing the funds of these banks, so that they may remain liquid.

The greatest danger that can come to this System is from the pressure of selfish elements that would want to see the System used for their own individual advantage. These are the men who say, "We don't see that the Federal Reserve System is of any use to us. Why should we not be permitted to go to the Federal reserve banks direct and secure a loan for us for any kind of industrial or agricultural enterprise?" But suppose that Congress could be persuaded (of which, I am grateful to say, I do not see the least evidence) that the Federal reserve banks should go into such ventures, what would be the consequence? The funds of the Federal reserve banks would be invested in local individual loans like those of any country bank. You would have added one more commercial bank to the thirty thousand already operating in the country (a large one, indeed, but in many cases not even the largest one); one more bank that would operate upon the same principles as the commercial banks of the country, and conditions, in that case, would in the end become substantially the same as they were before the creation of the Federal Reserve System. Why should it be safe to permit the banks of the country to count as reserve balances with Federal reserve banks when, as a matter of fact, this reserve money had been invested exactly in the same way in which they themselves could have invested the money? How could these loans be liquidated in times when the commercial banks are pressed and how, under such conditions, could the Federal reserve banks be free and prepared to act as the reserve lending power of the country, ready to loan when others had reached their limit?

When, after the panic of 1907, I wrote some articles dealing with the necessity of financial reform in the United States, I likened our reserve situation to a city where everybody had a pail of water but where there did not exist a general reservoir to cope with the emergency of fire, so that in case of such emergency each man held on to his insufficient little supply, while nobody had enough to fight the flames successfully. That simile has had "to work overtime," but everybody is now in accord as to the necessity of having these central reservoirs and they have been made operative with great success. But, gentlemen, beware of the men who are not satisfied with what has been achieved, but plan to drain your reservoir for irrigation purposes. If you do not keep the water reserved for the use for which it was accumulated, some one, no doubt, will profit, but when the fire comes there will not be an adequate supply of water. A great service that the business man, the farmer, and the banker of this country can render in the administration of the Federal Reserve Act is to disabuse the minds of all who would wish to see the Federal reserve banks conducted for their own individual purposes.

The policy of the Federal reserve banks must furthermore differ from that of the commercial banks in that the former must at times disregard earnings; for if they did not, they would, like the other banks of the country, run the risk of putting out their money in the largest quantities at the very time when the System should be quiescent and gather strength for the time when the pendulum will swing back.

Nor may the Federal reserve banks apply the general banking standard in considering their operating expenses. The expense of printing and shipping of circulating notes amounted to between $600,000 and $700,000 for the first year. The bulk of these notes was prepared to be kept in readiness or for the purpose of accumulating gold for the greater safety of the country. Less than $17,000,000 represent increased circulation from which a return is earned. It is a trying condition for those in charge of the Federal reserve banks to see their earnings low and their operating expenses high, but they would be guilty of neglect of duty if they permitted themselves to be influenced by the desire of earning dividends or reducing expenses rather than by the prime consideration of the safety of the country.

The Federal Reserve System must show its value to this country, not by what it does for the individual, but by what it does for the entire nation; by the safety that it provides for the entire country; by the safety that it provides for the depositor and for the borrower in dealing with his bank; by the reasonable and more stable rates that will the more thoroughly permeate the entire country the longer the System will be in operation. The more closely the banks can be drawn into the Federal Reserve System and the stronger the Federal reserve banks themselves grow, the more they can assert their influence as a regulative and, at times, corrective power. At the same time, while exercising these functions, it will be the task of the Federal reserve banks to be business institutions which earn their running expenses, and which, in due time, will earn their dividends also. When once they have gone through a period of active money they will easily find their proper place. Ultimately, as going concerns, they must control a substantial normal volume of business without which they could not possibly exercise their proper influence.

The much debated question, whether Federal reserve banks are emergency banks or competing commercial banks, will then be disposed of. They are neither quite the one nor the other. They will be Federal reserve banks, banks of a distinct character of their own, as the Bank of England, the Banque de France, and the German Reichsbank.

It is equally wrong to say that Federal reserve banks shall at all times compete with member banks as it is to say that they shall never compete with member banks. Federal reserve banks are at all times entitled to the business that the law permits them to engage in. But the true question is, as my colleague, Mr. Delano, put it recently, "What, for the best interests of the country, are the conditions under which they shall compete?" Stating the problem very broadly and allowing for many exceptions, is not this the answer: When rates rise above normal, Federal reserve banks will enter the market freely, prepared and eager to compete and to undertake an abnormally large amount of business. If rates are normal, Federal reserve banks will seek to secure a normal amount of business. If rates go below normal, however, the amount of their investments should go below normal. The present time has been one of abnormally low rates and that is why, under existing conditions, Federal reserve banks could not compete actively for a large volume of business, not primarily out of consideration for the member banks, but because, as a matter of policy and safety, Federal reserve banks must not assist in driving rates below a normal level in periods when they should preserve or accumulate a strong reserve power.

We must not overlook that, at this time, there has been paid in only a portion of the reserve moneys which are to become the deposits of the Federal reserve banks and that, until this process is completed, the relations between Federal reserve banks and their member banks will not develop that close intimacy which ultimately will be the basis of their intercourse. Moreover, we must give our banks a reasonable time for fully developing the new banking methods upon the use of which the success of the Federal Reserve System is largely predicated, that is, the free use of eligible commercial paper as a secondary reserve and of bankers' acceptances, a wide market for which will ultimately provide one of the regular fields for constant operations of Federal reserve banks.

Just a year ago, when the Federal reserve banks for the first time opened their doors, I ventured to say:

> The 16th of November may be considered the Fourth of July in the economic life of the United States. Coming generations will commemorate it as marking the foundation of our financial emancipation.

This statement to some may have appeared an exaggeration at that time. But just see, gentlemen, how quickly it has come true! If I knew how to do it, I would make that statement even stronger to-day.

I am looking back upon this first year with full satisfaction. We have been able to secure a remarkable group of men who have faithfully and enthusiastically devoted their energies to the hard and trying work of breaking the ground for future growth. No work takes as much care and is as little perceptible to the casual observer as that which is done in laying the foundation of a great structure. I am confident that it will not take long and that we all shall see the building rise.

The country had to be educated, and we all, from top to bottom, had to familiarize ourselves with the intricate and complex piece of machinery placed in our charge.

I believe that all of us who now, for a year, have been part and parcel of this new banking system, feel profoundly convinced that the fundamental and characteristic principles underlying the Federal Reserve Act have been fully vindicated. Some of my friends sometimes have stated that they believe me to be a "central bank man." If I were free to-day to choose for this country between one central bank or a system constructed upon the Federal Reserve principle, I should choose the latter. The Federal Reserve System, properly developed to its highest efficiency, will give the country the advantages of a central bank, which, in substance, are centralization of reserves and mobilization of commercial paper; but, at the same time, it avoids complete centralization which, while assuring higher efficiency and easier operation, would in our country prove a source of danger and attack. The law has placed upon the Federal Reserve Board the duty to so adjust from time to time this combined system of centralization and decentralization that these two forces balance each other so as to secure the most beneficial results.

This is a delicate and difficult task; but if Congress and the country will give us their confidence, I have not the slightest doubt that it can be done. It is not one of the least of the advantages of the Federal Reserve Act that it has created a Board which, daily watching the development of the Federal reserve banks, may be relied upon, when required, to give impartial and, I hope, competent advice concerning any defects that may become apparent in their operation.

It was a difficult problem to write so intricate a law as the Federal Reserve Act. It is a very remarkable achievement to have put upon the books a statute which has brought into life a system which has proved itself entirely workable and successful. It is only natural that there will be certain corners where the coat does not quite fit, and actual experience may from now on guide our hands in designing such adjustments as from time to time may prove advisable.

I have tried to explain to you to-night what the Federal Reserve System has done and what we may confidently expect it will do for you. I have thought that it might at the same time be interesting for you to know also what you can do for the System. You must help us to administer it as business men in charge of a public trust. In dealing with the problems and the policy of the Federal reserve banks we all must think on broad national lines. We must disregard the provincial or local point of view. Unless every one realizes this condition and coöperates with us in this spirit, our task will be difficult, indeed. Unless we administer it as a sacred trust for the benefit of all, we shall fail to bring to its highest fruition a System so happily organized and destined to be a most valuable factor in leading this country to safety and prosperity and at the same time to the position of a world power in commerce and finance.

JANUARY 25, 1916

XVI

SOME ECONOMIC PROBLEMS OF THE DAY

Address Delivered Before the New York Credit Men's Association at Its Annual Mid-winter Meeting and Dinner, New York City

THIS is the first time, since I have taken office, that it has been possible for me to accept an invitation to address a public gathering in New York and I assure you that it is a genuine pleasure for me to be back among my old friends and to enjoy their hospitality. I am very grateful to you for permitting me to speak to you to-night. Not that I enjoy making speeches. Indeed, I dislike inflicting them upon you as much as I dislike inflicting them upon myself. But, ever since I became interested in monetary reform, it has been my good fortune to meet from time to time with officers and members of your Association and I welcome the privilege of being able to-night publicly to acknowledge the debt of gratitude that the country owes the Association of Credit Men for the intelligent interest shown in this great work of banking reform and for the valuable assistance rendered in paving the way for its accomplishment.

The Federal Reserve Act could never have been passed had not the entire country gradually been educated to it, and in this campaign of spreading sound thought the share of the work done by your Association has been of inestimable value. But, gentlemen, I have come to-night "not to praise you," like Mark Antony, nor indeed, "to bury Caesar" under a mass of dry statistics, but to discuss with you our problems and the ways and means by which together we can best develop the work so auspiciously begun.

Our country is passing at present through a period of economic development the scope and rapidity of which have never been paralleled. Originally opened and developed by foreign enterprise, and until the fall of 1914 still dependent upon Europe for financing its foreign trade, and to a certain extent, its crops and its industrial undertakings, this great continent in less than two years has not only asserted its complete financial emancipation but has become for the present at least the world's banker.

Two factors have coöperated in bringing about this result: the European conflagration and the opening of the Federal Reserve Banking System. It may, therefore, be interesting and timely to consider to-night some of the phases of the interplay of these two forces and the policy and methods best to be pursued in meeting and directing their influence at this momentous juncture marking, as it does, the turning point in our economic history.

The far-reaching effects of the War as they have worked in favor of the United States and to the disadvantage of Europe are apparent to all. The effects of the opening of the Federal reserve banks are not quite so easily discernible to the casual observer.

The Federal Reserve System has created a condition of health and strength which is accepted by many as a natural state without thinking of the men whose thought and energy brought into life, at almost a providential moment, this remarkable piece of banking machinery. It is true, none the less, that without the steadying influence of this System, without the new machinery that it provided for the financing of our foreign trade, we should have sunk lower and should not have risen so far and so fast. Had it not been for this feeling of safety this country could not at one and the same time have absorbed its own securities and granted foreign loans estimated to aggregate together the staggering amount of one billion and a half to two billion dollars. And while these imposing transactions were being carried through, crops were moved at the lowest rates ever known. Without the usual seasonal fluctuations in interest rates and without a ripple of financial difficulty we passed through political situations which in years gone by might have caused violent financial disturbances. Panics such as we had become accustomed to expect as things inevitable have become phenomena of the past. At the same time some hundreds of millions of dollars were provided to pay off the long bills our bankers formerly drew on Europe for the moving of our imports and exports and for other credit operations, while simultaneously our own American bankers' acceptances sprang into existence. They are being drawn to-day from South America, the Far East, and from Europe for the purpose of financing not only our own trade but also that of foreign nations.

It has been suggested, however, that these results have been achieved as an indirect incident of the existence of, rather than as the direct effect of, the operations of the Federal Reserve System. We do not deny this fact, but we might well ask these critics whether they would measure the degree of efficiency of a municipal administration by the large number of murderers sent to the electric chair or rather by the small number of crimes committed.

After all, what is the real object of the Federal Reserve System? Stripping the problem of many important side issues is it not, in substance, to increase the safety of our banking structure and to bring about stability and, as far as possible, equalization of interest rates in the various sections of the country?

The service rendered by the Federal Reserve System must never be measured by the volume of its own business or by the amount of its earnings but by the degree of success with which it obtains its aims. Can you see in your mind's eye the curve representing the fluctuations of our past interest rates? You will find it to be a wild, zig-zag line rapidly moving up and down between more than 100 per cent and

1 per cent. Teach the country to watch that curve in the future; the straighter the line, the smaller its fluctuations, the greater will be the beneficent effect of our System.

There appears to be a great deal of confusion of thought about the proper functions of Federal reserve banks and the policy to be pursued by them in attaining the ends for which they have been organized, particularly about the question whether or not Federal reserve banks should or should not avoid competition with the national and state banks and trust companies.

The policy of the Federal reserve banks must be guided by one single consideration which is the public interest. Federal reserve banks must neither fail to engage in transactions which would redound to the benefit of the country, on the ground that these might entail expense or loss; nor must they, on the other hand, engage in transactions on account of the earnings to be derived, should these transactions or functions run counter to the public interest, or should they lessen the ultimate ability of the Federal reserve banks to render the largest service for the general benefit of the country.

In carrying out their policy they must neither compete for the sake of competition nor omit competing for the sake of avoiding competition. In performing functions with which they are charged by the law they must compete or not compete as the public interest requires.

The present maximum lending power of the entire Federal Reserve System on a gold reserve basis of 40 per cent is about $600,000,000. The total loans and investments of national banks amount at present to about $9,000,000,000; those of state banks and trust companies (including savings banks) are estimated at about $13,000,000,000. It is obvious that it cannot possibly be the object of the Federal Reserve System, by competition, to substitute a lending and investing power of $600,000,000 for that of all the banks of the country amounting to about $22,000,000,000. The aim of the System must rather be to keep this gigantic structure of loans and investments, which is largely carried by bank deposits, both from over-contracting and, as well, from over-expanding so that, as the natural and inevitable result, it may not be forced to over-contract.

Effectively to deal with the fluctuations of so gigantic a total is a vast undertaking. If the task is to be accomplished successfully, it cannot be by operations which are continuous and of equal force at all times, but only by carrying out a very definite policy which will not only employ funds with vigor at certain times but with equal determination will refuse to employ funds at others. That during periods of actual employment the Federal reserve banks will make large earnings, and that during periods when a restriction in the activity of Federal reserve banks is indicated by general conditions their earnings will or should be smaller, are incidents which have no bearing upon the measure of their usefulness. Federal reserve banks, when accumulating and keeping idle their funds, are exercising as useful a function as when they are employing them. If safety and the stabilization of rates form the soundest foundation for general prosperity everything that the Federal reserve banks do in avoiding excessive rates—whether these be too high or too low—will redound to the benefit of the nation. If the potential or actual employment of $600,000,000 can have this effect upon loans and investments of $22,000,000,000 (of which $16,000,000,000 are loans and discounts) the usefulness of the Federal Reserve System is proven. That does not mean that we shall ever have to contemplate conditions under which the entire funds of the Federal reserve banks will lie idle. A certain proportion will and must always remain in active service, as a regulatory force. As their field of operations increases and as the circulation issued by the national banks is reduced, doubt about their ability to earn their running expenses will disappear. Ultimately, Federal reserve banks will have no difficulty in earning their dividends,—when once they occupy their proper position and when they have had the opportunity of averaging their operations over a reasonable period. But a fair time must be given them for reaching this condition.

We must not forget that it took the European large central banks many years, often generations, to secure their present dominating strategic position. And we must furthermore be mindful of the fact that the Federal Reserve System at present is operating in a period when the curve showing our interest rates must be considered as strongly subnormal, thus clearly indicating for Federal reserve banks a policy of conservatism.

The lending power of the Federal reserve banks, though very large, and though, in emergencies, it can be vastly increased by the Board's power to reduce or suspend reserve requirements, is, after all, definitely limited. Moreover, constituting, as it does, the reserve power of the country, it cannot be drawn upon beyond a certain point without creating alarm.

The regulative influence of the increase or decrease of interest rates must, therefore, be applied from time to time, and the more readily bankers and business men coöperate in the policy thus indicated by the Federal reserve banks, the smaller will be the variations to be expected excepting, of course, periods of extraordinary disturbances at home or abroad when more drastic measures may be needful.

To bring about stability of interest rates two things are necessary: First, judicious withholding and, in turn, judicious employment by Federal reserve banks of their lending power; and second, recognition by banker and business man that the measure of success to be achieved by the Federal Reserve System will to a certain extent depend upon the degree of their own coöperation with the policy of the Federal reserve banks.

And this leads me to a phase of the problem concerning which I am particularly anxious to speak to you to-night. That is the coöperation of the business community in bringing to the fullest fruition the service to be rendered by the Federal reserve banks.

Until now we have been laying the foundation and installing the machinery for future operations. I believe we have now fairly finished this first part of our task and further development will from now on depend to a large degree upon the banks and the public.

In order to remain liquid and deserving of the unqualified confidence they require, reserve banks must employ their funds in investments of the most liquid character only. The larger the amount of such paper that is available, the larger will be the field of operation open to these banks, and the better can they perform the function of either employing their funds freely or, with equal freedom, collecting their maturing paper and keeping their funds idle when that course is indicated. In order effectively to develop their operations Federal reserve banks cannot depend upon the borrowing requirements of their member banks alone since that, in many districts, would be a wholly inadequate field for their activities. The first year's experience has already shown that they must look largely to open-market operations, such as purchases of bankers' acceptances, bills of exchange (including trade acceptances), warrants, United States bonds, etc., in order to secure their share of business and influence.

Their most important field in this respect is the bankers' acceptance, the use of which, it is confidently hoped, will from now on steadily increase. Unfortunately the development of this method of financing importations and exportations has thus far been comparatively slow. Either the merchant or the banks, or both, lack the full appreciation of their opportunities—we might say of their national duties—in this respect. While great headway has already been made, and while it is realized that real progress must be gradual, and that some of the foreign banks now occupying the field are blocking our way as much as they can, we ought, nevertheless, be further advanced in this direction than we are to-day. With our acceptance discount rate at about 2 per cent against the British discount rate of about 5 per cent, with our exchange for dollars high and secure, while European exchanges are low and unstable, we ought to-day be doing a larger acceptance business. A few of our banks have been very energetic; others have been wholly inactive, partly because of ignorance of the methods to be employed, partly because of their inability or unwillingness to secure men who are expert in this business. Some banks, I suspect, prefer at this time to make cash advances rather than to grant acceptance credits, because they wish to employ their own funds. That, however, is short-sighted policy. Every effort ought to be bent at this time both at home and all over the world to introduce the use of our bankers' acceptances. It is inevitable that at the end of this unfortunate war we shall be the one nation to which logically the world will look for credit facilities. To grant these acceptance credits will be one of the functions which, from now on, we shall be called upon to perform in a constantly growing measure. Not only is it wise for the accepting firms to take up with energy this branch of banking but, for the future of the Federal Reserve System, it is of the utmost importance that our banks should hold as an asset hundreds of millions of this most liquid paper which at any time they can dispose of to the Federal reserve banks. This will not only widen the field of operation open to our Federal reserve banks but will prove a source of safety for us in our international financial relations. Incidentally, I am looking forward to the time when even country banks will carry these bankers' acceptances as quick assets rather than demand balances with other banks.

The Federal Reserve Board hopes that we may succeed in securing a broadening of the powers of national banks so as to permit them to accept, not only against transactions involving the importation or exportation of goods, but also against domestic transactions secured by the pledge of readily marketable staples, by goods actually sold, or by shipping documents covering goods in course of transportation. It is easy to see the great influence that such an amendment to the present law would have in equalizing rates. If cotton, properly warehoused in Texas, can be pledged to an accepting bank in Texas, Chicago, or New York, the proceeds of the acceptance at the discount rate of, let us say, 2 per cent would flow from whatever would be the lowest discount market into Texas and relieve the banks in that district.

And here we touch upon a point that I wish to impress upon your minds, namely: equalization of discount rates is dependent upon standardization of credit, and it cannot be brought about by legislative enactment or government machinery, but only by the action of the banks and business men themselves. Farmer Jones may be able to secure money from his bank on his own note only at 6, 7, or 8 per cent, but if he can store his grain or cotton with a properly organized warehouse and secure the acceptance of a good bank the bill will sell at the lowest rate, provided the accepting bank is sound. It does not matter whether money at that time be higher at New Orleans or Minneapolis than at Chicago or New York; if the New Orleans or Minneapolis bank's acceptances are good they will sell substantially at the same low rate as those of the banks in Chicago and New York. Raise the standard of banking and warehousing—use modern banking methods—and equalization of interest rates must follow automatically. No law will ever remove the difference between good and bad. There are different grades in cotton and grains and, similarly, there are different grades in credit. We cannot equalize credits but we can bring about equalization of interest rates for similar grades of credit all over the country.

And now a word about trade acceptances. I have read with the keenest interest the very intelligent articles that you have published in the Bulletin of the National Association of Credit Men, and the speeches made by your officers concerning this topic, and I congratulate you upon the excellent work that you are doing in the matter. You have clearly pointed out that the trade acceptance offers the great advantage of converting a non-negotiable book account into a live liquid asset, and you are doing a most valuable work of education when you teach the merchant or manufacturer that, under the present system, having sold his goods he has to borrow on his own promissory note, using his own credit while, if he adopted the system of trade acceptances, securing the obligation of the customer purchasing the goods, he would be selling an asset instead of incurring a debt. You have so forcibly pressed home all the arguments concerning this problem that I should not know how to add to them. I can only express my great satisfaction at finding myself in such complete accord with you. When it comes to the question of the eligibility of single-name paper for rediscount with Federal reserve banks I always have a kind of David Harum feeling: "Yes an' no, mebbe an' mebbe not." Because of this doubt we have felt that we had to ask for evidence in order to be certain that such a bill complied with the law as to the use of its proceeds. The trade acceptance, on the other hand—unless it be fraudulent paper—carries on its face the assurance of its legitimacy. It evidences a definite debt of the purchaser to the seller to be liquidated on a definite date. The Board has, therefore, encouraged reserve banks and their customers to offer for this kind of paper a rate of discount lower than that for single-name promissory notes. It is greatly to be hoped that its free use will grow. National banks may endorse these trade acceptances without limit, while the endorsement of single-name paper to banks or individuals other than Federal reserve banks would, under the

National Bank Act, count as a liability which, as you know, is limited for national banks to 100 per cent of capital. As our System further develops, good trade acceptances will, therefore, become an investment preferred by member banks and selling at a rate lower than enjoyed by single-name paper. The more good paper of this kind is developed, the more will it be used by the banks as a secondary reserve, and the more general will become the habit of rediscounting this paper—particularly for short maturities—with the Federal reserve banks.

It is the first duty of Federal reserve banks to be liquid. Therefore, they must invest only in the better grades of paper offering through their acceptances or endorsements satisfactory guarantee as to prompt payment upon maturity. The more freely these trade acceptances are endorsed and standardized the wider, therefore, will become the field of operation of Federal reserve banks. Under the law Federal reserve banks are permitted to buy this double-name paper even without the endorsement of a member bank. Personally, I should not be surprised to see the gradual establishment of rates favoring trade acceptances as against promissory notes even to a further degree than in the past.

You may, therefore, feel certain that the work you are doing in encouraging the use of trade acceptances is of great value to the growth of the Federal Reserve System and of sound credit and banking.

In actual operation the problem of the Federal Reserve System is, like your own, largely one of analysis. Success or failure in banking and business are largely dependent upon careful analysis both of the individual statement and the condition of the entire nation, indeed of all the world.

The Federal Reserve System is a structure essentially based on gold and confidence (that is, credit) and in order to be safe and sound it must be possessed of an effective machinery for judging credits from the smallest to the largest units.

You can, therefore, readily see how important for us is the work of credit analysis done by the members of your Association. Your efforts and those of our banks, in many respects, run in the same direction. The Federal Reserve System, like you, believes in and insists upon frankness. Our member banks are required by law to make full statements. We think that an ounce of prevention is better than a pound of cure. If our Federal reserve banks carefully study the statements made by their member banks we shall, as we go forward, avoid serious trouble by detecting and correcting it in its early inception. This same principle we strive to have applied by our member banks in dealing with their own customers, and our insistence on their receiving statements will render it easier for them to overcome resistance in this respect on the part of their customers. There is safety—not only in numbers—but also in frankness! On the whole I suppose it is your experience, as it has been mine, that if a man says that he is too proud to show his statement the statement generally is not one to be proud of. Your call for frank and intelligent credit statements and your ability to draw proper conclusions therefrom will prove of the very greatest importance to the safety of our banking system.

When from the individual statement we turn our attention to the credit statement of our country and to that of the entire world we must confess to great perplexity. It is the duty of every conscientious captain of banking or industry to look ahead and ascertain as nearly as possible the future course of the two great forces of demand and supply. But the standards of past experience cannot be applied in the present unprecedented situation and our economic future will depend on many factors which we must still consider as hopelessly unknown. One of the most important items in the equation will be the degree of exhaustion which the unfortunate nations now involved in a death struggle shall reach; and this, in turn, will depend upon the time over which the contest shall be prolonged. We can, therefore, safely speak only of the broadest aspects of the subject. What we may say with confidence is that if our creditor position is not weakened, the end of the War, no matter when it may come, will find us so greatly strengthened as compared with the leading European powers that we shall almost inevitably take our place as a world's banker. It will probably fall to us to finance these nations, at least to a certain extent, and for a time. On the other hand, there is the danger that this new business that has come to us owing to extraordinary conditions may mislead us into building an expanded credit structure upon an unstable foundation of shifting gold—some of which we may not be able to hold permanently—and a heavy industrial structure upon a basis of ephemeral demand. This danger is real and so we find at present two schools of thought, one looking into the future with unbounded confidence and the other anticipating drastic reaction and collapse. But if this danger exists, as no doubt it does, do we, like the old Greeks, believe in an inexorable fate, and must we bend our necks and patiently await the blow? Or is it not worth our while to deal with the problem of our economic future as science has dealt with yellow fever and cholera? In other words can we not, by scientific research, recognize the elements of the problem and find the means of warding off the danger?

Turning first then to an analysis of our banking problem we should bear in mind that added lending power—be it by decreased reserve requirements or by an influx of gold—does not automatically bring about the increased opportunity for making safe local loans. Only gradually and only as we shall recognize it for the support of our permanent and solid growth of business—not the mushroom kind—shall we be able to use it. The danger of a rapidly and abnormally increased lending power is that it makes for plethora of money, for too easy rates, exasperating alike, the banker and the investor, and that consequently it brings forth the tendency of encouraging unhealthy expansion and of making poor investments at home and abroad. Such conditions have always been the breeders of economic disaster.

We must furthermore bear in mind the old rule that between countries of fairly equal credit conditions low interest rates will have the tendency of driving gold to that center where it can earn the higher interest return. While abnormal conditions have for the present destroyed the power of interest rates to direct the flow of gold, sooner or later normal laws of economics will again assert themselves and we must then expect that, owing to the inflation of currency created in almost every country involved in the War the demand for our gold will be very keen and determined. We may then have to part with very large sums of gold but we must so direct our course as to be able to control this outflow and let it take place without creating disturbances in our own economic life.

In order to avoid unfortunate developments we must then first of all "keep our powder dry," that is, hold in reserve the essential strength of the Federal reserve banks, not only to be prepared for a possible drain or emergency but, also, so far as practicable, to offer a check to inflation.

Impatience by the public or by the Federal reserve banks themselves to quickly show results by large profits must not be permitted to lure us from a safe course. Strange as it may seem the words of Milton, "They also serve who only stand and wait," may be aptly applied to so modern an organization as the Federal Reserve System. To stand and wait is often the hardest of all duties, requiring more courage than to follow one's impulses in "letting go."

Second, we must greatly increase the degree of our control over our current gold supply by assembling, as far as practicable, the gold now wastefully carried in the pockets of the public, substituting for it our new elastic reserve notes.

Third, we must take the utmost care not to destroy at this time the basis of our future lending power. Whatever foreign loans we may make during the War ought to be of reasonably short maturity so that we may keep control of our gold in case we should later wish to have it at our call. That will give us a strategic position at the end of the War so strong that we shall be able effectively to face the various duties that will confront us, not only towards our own country, but also towards the world at large.

Fourth, while short loans are advisable in dealing with foreign countries this is the time for us to set our own house in order and arrange for the financing of our healthy home enterprises on a permanent basis.

Fifth, our banks have so far acted wisely. They have not considered the reserve now prescribed by the Federal Reserve Act as the actual limit of their reserve condition. They have, generally speaking, held reserves in excess of that limit. It is, however, true that, with some this is not due solely to prudence but partly to the fact that the great ease of money made it practically impossible for them to invest a large percentage of their available means. Increased activity might bring about a change in this respect. But I believe that it should be impressed upon all the banks that, rain or shine, they should under present conditions continue to keep their reserves far in excess of the present legal requirements and that they should not forget that, on balance, this year they will have to pay into the Federal Reserve System roughly $110,000,000 and that if the old standard of reserve requirements were in force to-day the reserves now shown would be reduced by about $500,000,000.

If a policy of general conservatism, such as I have outlined, can be systematically followed, thereby maintaining the strength of our banking position, we shall, in due course, reap our reward.

I do not by any means intend to suggest undue restriction upon legitimate industries. I recommend, however, a careful discrimination between that portion of business and industry which is solid and permanent and that which is of a purely ephemeral or speculative character. The former should be advanced and fostered by every means in our power; and it is the duty of our bankers and of the Federal Reserve System to supply it with its due share of credit. There is no reason why the regular business of this country should view the future with alarm. While, as I have stated, it is to be expected that, at the conclusion of the War, Europe will make great efforts to reëstablish her industries and to reopen her markets it is equally true that Europe is short of raw materials and that, before the full force of her industries can be brought to bear upon our markets, she must buy many of these raw products largely from us. Moreover, it will take time to reorganize her industries which now, to a large extent, have been turned into factories producing those articles that are required by a nation at war. It is, therefore, not to be feared that the reaction will come immediately upon the conclusion of peace; and therein lies a protection which is an important consideration to be borne in mind by our business men when dealing with the problems of our home consumption. American prosperity is of a self-igniting character; one branch of business reacts upon the other and the increase in activity reacts again on the very forces that first acted as the moving influence. The present wave of prosperity in the United States appears too powerful to be easily rolled back or resisted and there would seem to be no reason why business, so far as relates to our own normal demand and consumption, should not continue to be brisk. I believe that we may say with reasonable assurance to the business men and manufacturers dealing with our own local requirements, "Be not afraid and go ahead."

The case is quite different with those industries that are temporarily over-stimulated by passing conditions and are using their resources to extend their plants in order to cope with these extraordinary demands. Very possibly such plants, in many instances, are built from profits and their owners may be well able to afford to "scrap" them upon the arrival of peace. They will not, however, adopt so heroic a course and we must, therefore, recognize in these investments containing, as they do, possibilities of over-production, the seeds of grave danger. To those who are engaged in such industries the banking and business community might well utter a word of warning. Let them use their profits, not in expanding beyond the limits of prudence, but rather in developing their existing facilities to the highest possible pitch of efficiency.

Has not last year's experience shown us the excellent results that concerted effort can produce in dealing with problems of this kind? The educational campaign for a diversification of the crops which resulted in a largely reduced output of cotton in the fall of 1915 brought prosperity to the South, while another large cotton crop on top of that of 1914 might have proved fatal. May we not hope that we may be able to deal scientifically with questions of manufacture as well as those of agriculture? The country will need its highest degree of efficiency most urgently when, after the War is over, we must meet the competition of European manufacturers forced by necessity to strain every nerve in producing at the lowest possible cost, and under the heavy handicap of weakened exchange standards, strained or exhausted credits, and high taxes.

If we are prudent and avoid both banking and industrial inflation, if we use this period of affluence and unexpected protection to increase our efficiency and complete our organization, I do not see why we should not calmly trust our ability and intelligence in meeting any emergency the future may have in store for us. It is with this point in view that I so strongly urge our bankers not to lose this opportunity of perfecting our banking machinery for the purpose of developing relations with foreign countries. The only distinct effort in this direction has been made in New York and, to a certain extent, in Boston and Philadelphia; the rest of the country appears to be so busy making money that apparently it has not found the time to provide for the future.

Our opportunity for successful foreign trade has been vastly increased because foreign business is carried on largely on credit, and in granting credit the United States will, after this war, be stronger than any other country. There is a close interrelation between loans to foreign nations and business transactions in those foreign countries. It is true that foreign loans stimulate foreign trade, but it is equally true that it is impossible to place large loans unless there exists in the creditor country an intimate knowledge of the condition of the debtor nation. If thousands of our merchants know South America or the Far East, and spread their knowledge in our country, they will create that atmosphere of intimacy and confidence without which it is absolutely impossible to create an extensive investment market for foreign securities. In the past we have not conquered foreign markets to a greater extent largely because we have been too prosperous at home and because we did not think it worth while to accommodate ourselves to foreign methods or to grant credits in far-away countries.

The enormous lending power that we shall enjoy will give us a tremendous advantage in the future. It will be for the American business man and investor to decide to what degree the United States shall become a nation of world bankers. Our great prosperity should not make us forget those opportunities, almost beyond measure lying at our door, and which on account of our present prosperity we should not be guilty of neglecting.

I am very grateful to you, gentlemen, for having permitted me to discuss with you to-night some of the problems as they touch your own individual work—that of the Federal Reserve System and the larger aspects of these questions as they affect the entire nation.

The ultimate outcome of the most gigantic of all struggles ever fought is still shrouded in mystery. But, out of the mist, our future looms large, resplendent with opportunities, yet burdened with serious obligations. Simply to wax prosperous through the misfortunes of others cannot be the destiny of this great country. Sometime and somehow the future must bring us an opportunity of giving back to the world in service what fate is now lavishly throwing into our laps. Whatever our tasks and duties then may be, I know that you business men of the United States will meet them in the same broad and helpful spirit that has guided you in the past in struggling with the problems of our country.

MAY 3, 1916

XVII

PROGRESS IN THE DEVELOPMENT OF BANKING RELATIONS BETWEEN AMERICAN COUNTRIES

Address Before the International High Commission at Buenos Aires

IT is less than a year ago that I had the honor of addressing the First Pan American Financial Conference, and it is, indeed, a great pleasure and privilege after so short a time to meet again with the distinguished delegates to this convention and to take part in their deliberations. Before venturing to express the few thoughts that I should like to be permitted to present to you on this occasion, I wish to apologize for the temerity of attempting to address you in Spanish. The better the stranger knows your exquisite language, the more he grows to love it; but, at the same time, the impossibility of doing justice to it is forcibly borne in upon him, and the keener grows his disinclination to mar its beauty by daring to speak it. If, nevertheless, I am so bold as to undertake this venture, it is because I am conscious of the fact that the spoken word—no matter how poorly pronounced—is able to convey one's sentiments with their full degree of sincerity and intensity, while the translated word—no matter how excellent the interpreter—transmits one's thoughts, to use a banker's expression, with the loss of a very heavy discount.

I am most desirous to impart to you in an undiminished degree of warmth and sincerity the greetings of the Federal Reserve Board, the Federal reserve banks, and the entire banking community of the United States, and their hearty wishes for the success of this gathering. Before sailing I was in frequent conferences with the financial leaders of our country, and I bring you on their behalf and on behalf of my colleagues of the Board the assurance that they are most deeply impressed with and keenly alive to the opportunities offered and the duties imposed by the change of economic conditions brought about by the European War. Our bankers and merchants alike want you to know that they wish to do everything in their power to bring to the promptest and fullest development the financial and commercial relations with our sister republics of this hemisphere. If you would study our newspapers you could not but be impressed with the fact that at all our business men's and bankers' conventions these relations form the leading topic of discussion. And if you would examine the lecture courses at our institutions of learning you would find that never before in the annals of the United States were there as many young people studying the Spanish language and the economic and political history of Central and South America as at present. The American colossus is moving. Like a snowslide its incipient motion has been slow and hardly perceptible, but it is under way and I believe I may say with confidence that it is gaining in impetus with every hour and that nothing can stop it from reaching its ultimate goal.

In order that you may see that not mere hopes and wishes but actual facts are the fathers of the thoughts just expressed, permit me to explain to you in a few words what has been achieved in the United States since our last meeting and the work being done at this time.

At the conclusion of the address which I had the honor of delivering before you on May 25th, I summed up the financial problems of American nations in the following words:

> The development of all American nations lies in the same direction, though there will be a difference in degree. It must be the aim of the United States from now on to move rapidly toward entire financial independence. It must be the

> aim of her sister republics so to divide the credits needed for their further development that the temporary breakdown of one creditor country will not seriously embarrass them. They will enjoy the greatest degree of safety in this respect if their creditor nations are geographically, politically, and economically separated from one another as far as possible. So that in case one should become involved the other may be expected to remain unaffected thereby. Though in normal times closely connected with Europe, the American continents ought to be so organized as to form a distinct and independent unit in times of emergency—a union whose transportation and credit systems will remain unbroken, even though all Europe should go to war.
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> An American union of this kind will prove of the greatest economic advantage for all nations concerned. If such a union be thought desirable, it must, however, be forged and riveted every day of the year. If it is to stand the test of time and stress, it must be a structure of gradual growth, carefully planned and consistently developed, and built upon a safe foundation.

The first part of the program here mapped out was the financial emancipation of the United States. Our own financial independence had to be accomplished before we in turn could expect to become a permanent factor in relieving the dependence of other nations. This development has taken place in an incredibly short time. Not only have we paid our debts in Europe, bought back our own securities to an amount which staggers the imagination (estimated at one billion dollars), but we have also made loans to foreign countries aggregating over a billion dollars. (Of these Canada received $150,000,000, Europe $785,000,000, and South and Central America about $76,000,000.) We have in addition imported more than $500,000,000 in gold. Our excess of exports over imports since the beginning of the War amounted in January, 1916, to over two and one-half billion dollars, and to that extent the international financial position of the United

States as an economic unit has been consolidated during that period.

Since December 31st, 1914, the deposits of the national banks alone have grown by one billion dollars and the excess reserves in February, 1916, amounted to 882 millions. The latter figure indicates the tremendous reserve loaning power of the banks, which does not include that of the Federal reserve banks nor the state banks and trust companies.

I have taken the liberty of presenting these figures not from a spirit of boastfulness; indeed, it is with a feeling of deep sorrow and sympathy that we consider the causes underlying this phenomenal development. But it is necessary for us at this juncture to consider facts. Like physicians we must diagnose and treat our cases upon the basis of the patient's condition as it actually exists, and not as we should wish it to be. These facts, then, we must bear in mind:

The world's saving and reserve power has been heavily encroached upon; for many years after the War, Europe will not be able to send money for permanent investment to foreign countries to the same degree as in the past; the United States has so strengthened its economic position among the nations of the world that to a substantial extent it must take the place of the European nations that acted as world bankers before the War; and finally, the longer this deplorable struggle lasts the larger will become the share ultimately to be borne by the United States.

The first step of the program of the United States has been carried out with a rapidity and to a degree far exceeding our expectations of a year ago. We may then ask ourselves why it is that in the face of this tremendous increase in strength of the United States, there has not been a more aggressive policy on the part of that country in carrying out the second part of the program, that is, in actually securing a substantial portion of the banking business of the central and southern countries of the Western Hemisphere, and in developing our mutual trade relations covering both the imports and exports of these nations.

We might say in reply that all solid progress in business must be gradual and that work done on the foundation of a building is the most difficult and most important part of the task, but one that is least discernible to the casual observer. What important steps, however, have already been taken we shall state a little later and shall first enumerate the causes that up till now have worked for delay.

It is evident to all of us that as long as there is uncertainty as to the outcome of the European struggle, as long as it is impossible to judge how far the final destruction of property and credit will go, bankers in the United States will have to proceed with care and keep themselves supplied with ample resources so as to be prepared for any conditions that may arise. This attitude of conservatism is strengthened by the consciousness of the fact that large sums of North American securities are still in the hands of European investors and will still have to be absorbed by the United States. We may even expect that it may become advisable for Europe to sell us a substantial portion of their South- and Central-American securities. Our bankers are still puzzled whether they will have to enter the field of financing the large corporations of Central and South America by a process of substitution or by way of new transactions. Furthermore, Europe has been showering upon the United States orders for raw products at very high prices and for finished merchandise in such quantities and upon such terms that our manufacturers and bankers have been captivated by this highly profitable business. This, however, has prevented them from going out into the world trying to conquer new markets that would become of permanent value even though for the time being they offered less profit and required greater effort.

Considering the future of our country, the historian or economist might possibly say that it may prove a mistake for our nation to have concentrated its efforts at this time upon the execution and financing of ephemeral business bound to stop after the War, instead of employing this period for the purpose of laying the foundation for business relations of a more permanent nature. But a nation's business, commercial and financial, is a composite of thousands of individual transactions beyond the control of a government or a people, and it is after all the rule of demand and supply that governs supreme in economic questions. The fact remains that this extraordinary demand upon such extraordinary terms has created a scarcity of certain raw products and of labor, and at the same time an increase in the price of both. The manufacturer has thus been kept occupied indeed, but too preoccupied to find the time, men, and material necessary for securing new markets. The banker, on the other hand, in the face of a political situation that from time to time has been seriously clouded, uncertain of the requirements that the future may have in store for him, has been fully justified in proceeding with due care.

In spite of all this, greater headway would have been made if there had been in the United States a better knowledge of requirements and conditions of the countries of South and Central America, and if the law had permitted our banks to take an interest in the capital of banks operating in foreign countries. Before our section of the Commission sailed, the Federal Reserve Board recommended to Congress an amendment to the Federal Reserve Act designed to enable the banks of the United States to enter this field substantially on the same basis as their European competitors. This amendment has been warmly endorsed by the American Bankers' Association, several important members of which have assured us that they are impatiently awaiting its passage in order to embark upon this new field of banking. The Federal Reserve Board hopes, in the very near future, to receive news of the enactment into law of this amendment.

But in spite of the handicap under which we were thus proceeding, we have made very substantial headway. Two banks—The National City Bank of New York, and the Mercantile Bank of the Americas—have entered the field by opening branches in Central and South America, a large finance corporation has been established designed to go into foreign fields, and finally, but most important of all, the American acceptance business has been launched and is now well under way. Banks and bankers in the United States have acceptances outstanding estimated to aggregate between one hundred and one hundred fifty million dollars. That is a very substantial beginning, but only a beginning. Our bankers are only too anxious to increase these acceptances to a sum vastly in excess of that amount and the Federal reserve banks will continue to lend their vast resources in order to secure a wide and favorable market for these acceptances. At the present discount rate for dollar acceptances of 2 per cent as against the English rate of 5 per cent, and with the high rate of exchange commanded by the dollar, these acceptances ought to be increased by leaps and bounds and used to finance not only the trade of Pan American nations with the United States but also a portion of their trade with Europe. It would appear, however, that the local banks of South and Central America ought to give their more active coöperation and support in order to bring about a more rapid development which would benefit their customers individually and their countries as a whole.

There is, of course, the one great obstacle in the way of the free use of our banking facilities and that is the lack of quick and regular communication between South and North America. Banking is largely a question of interest charges and against the advantage of our low discount rates there is the disadvantage of the delay in getting American bills accepted and the proceeds made available. Every additional day needlessly consumed by the goods on their way toward distribution means either an unnecessary addition to the cost to the consumer or a loss to the producer. Quick and regular means of communication are the indispensable prerequisites for the successful development of North American banking in South and Central America.

But without going into a detailed discussion of all the phases involved in these interesting questions, I shall confine myself to emphasizing only these three points:

1. With the Panama Canal in operation, a letter between Valparaiso and New York should reach its destination in less than 11 or 12 days, two more days will be necessary to connect Buenos Aires and New York, and there is no difficulty in finding a prompt and regular route from Buenos Aires to Rio de Janeiro. It can only be a question of a very short time then, and—in one way or the other—we must succeed in solving this all-important question of a swift and regular ocean transportation. Forces that now work as obstacles will then be turned into influences favoring banking and business relations between American nations.

2. Our merchants and manufacturers realize that after the end of the War, Europe will have to make gigantic efforts to regain her lost ground and that the United States must be prepared to feel this competition even within her own borders. It is therefore necessary for the United States to look for new markets for her products and this naturally will lead our business men to increase their efforts in gaining a strong foothold in Central and South American countries. Some of our large interests have already become important factors in this direction, but if the growth is to be solid, it must be gradual, as was Europe's progress. After all, not a few large transactions, but the thousands of individual ones, form the best basis for the permanent establishment of extensive business relations between nations.

3. The financial condition of the United States after the War will be such as to make it an absolute necessity for us to take a very important share in financing the world. There

is no intention on our part to endeavor to crowd out the European nations that have been the friends of the South and Central American countries and have been substantial in developing them, as, indeed, they have been substantial in developing our own country. But the figures that I had the honor of presenting to you in the first part of my remarks tell conclusively their own incontrovertible story.

It is not any longer a question of hopes and wishes, but a question of mathematical certainties. And it does not now, as it did a year ago, take any degree of bold prophecy to foretell what the outcome must be. The United States now is and from now on will be one of the world bankers. I believe I am voicing the unanimous wish of all American nations if I say that we fervently hope for an early cessation of hostilities; the sooner they cease the better for us all. For the longer the War the greater the destruction of the world's saving power and the greater the resulting retardation of the entire world's economic progress.

We do not wish Europe's financial power to be crippled and ours to grow at her expense. The world is too large to be financed by any single nation. For the American nations' safety and independence lies in dividing their risks both as creditors and debtors. In any emergency, that will assure them the best protection. It is to this goal that we are moving with consistency and determination.

I apologize for having taken so much of your valuable time, but I thought it might be interesting and possibly useful for this Conference to be kept advised as to the progress made in our country, and to recognize clearly the strong economic forces that are at work in carrying into effect the second part of our program and that, without the least doubt whatsoever, will gradually lead to the establishment of the most intimate business and banking relations between the northern and central and southern Americas. It will be for this Conference to consider what ways and means may be devised to accelerate this certain evolution, and we confidently count upon the frankest expression of your views as to what the business and financial communities, as well as the government of the United States, may contribute in order to serve most effectively our common purposes.

The main service rendered by the so-called "exchange professors" is not so much in what these men teach while they are in foreign lands, but in what they learn themselves and, upon their return home, teach their own people. We members of the United States Section have come to learn, not to teach, and shall be happy by personal intercourse with your bankers and merchants to learn how our people at home may best aid further development on lines desired by us all. Mr. Kains, Governor of the Federal Reserve Bank of San Francisco, and myself, being the members of our Section especially charged with the duty of studying the banking questions to be dealt with by this Conference, shall devote our particular attention to the gathering of such information as your bankers and merchants may impart to us.

Progress must be made step by step. But where the governments and the people have so earnestly set their minds upon weaving and strengthening the commercial and financial ties linking the three Americas, where all economic forces point so clearly to a strong development in that direction, where—finally—distinguished representatives of all American nations are here united with such singleness and sincerity of purpose, there cannot be any doubt as to the beneficent results to be achieved by this Conference.

The members of the United States Section of the International High Commission consider it a great privilege to be permitted to do their share in this important and inspiring work for the success of which they know they have the best wishes of the entire business and banking community of the United States.

Report Submitted by Delegates of United States Section at First Meeting of International High Commission, at Buenos Aires, April, 1916

When weighing the advantages and disadvantages of establishing a uniform gold standard in the American hemisphere, it is necessary to look well into the future. While at present some of the American republics are still far away from a circulation actually based on gold, we must bear in mind that sooner or later we may expect to see gold standards established by a majority of them. It follows, therefore, that any action that does not make for this result will really be an obstacle to its final attainment.

The advantages offered by a Pan American monetary union —formed somewhat along the lines of the Latin Union for the purpose of establishing interchangeable coins—are self-apparent. If all American nations would coin gold of the same fineness and based upon the same unit of weight, the coins of one nation could circulate in the others, the expensive process of remelting and recoining would be eliminated, and financial transactions between all these countries would be greatly facilitated.

It is to be borne in mind, however, that there are very few of the American nations which at present have a free gold circulation. Of those countries that have a gold standard, the larger number use the gold either as a basis for a gold exchange standard or for the purpose of sustaining a paper circulation. In both cases the gold is almost entirely in the hands of the respective governments, and it would be a comparatively easy matter to recoin this gold, a process which would in no way interfere with the paper money now actually in circulation and secured by this gold. When once, however, this gold becomes the actual circulating medium, a later reform, if at all practicable, will be so much the more expensive.

As a case in point we might consider the United States, where gold and notes exchangeable for gold are circulating to such an extent that any change would in effect be an impossibility at the present time. If uniformity of standards is to be sought, it may be well, therefore, to bear in mind that any development on lines as here contemplated must in the nature of things give due consideration to this fact and, furthermore, be very gradual. It cannot be taken up simultaneously by all nations, but only by such as from time to time may find themselves in a position to do so. It would appear that those nations that already have adopted a gold standard of a fineness of .900 are fairly far advanced toward the ultimate goal.

On this point there appears to be unanimity among the delegates and the general consensus appears to be that it should be recommended that all American nations should, as rapidly as circumstances permit, adopt this fineness of gold of nine hundred thousandths.

Whenever a country could arrange its coins in such a way that its unit would be of this fineness and be a simple decimal fraction or multiple of the coins circulating in another, coins of both nations might circulate freely in the respective countries as part and parcel of the recognized circulation of such countries.

The United States members of your committee take the liberty of submitting the following suggestion, which may possibly prove helpful in further developing the problem under discussion.

Under the auspices of the Federal Reserve Board there has been established in the United States a so-called "gold clearing fund" at Washington. This fund has for its object to eliminate unnecessary shipments of gold and to facilitate the exchange of gold balances between the various Federal reserve banks by exchange of credit rather than by physical transfer of the metal.

To illustrate: Gold paid in at the Federal Reserve Bank at

San Francisco will, if desired, be credited to the Federal Reserve Bank at New York, the Treasury issuing gold order certificates in New York while the gold remains in the Subtreasury at San Francisco. The underlying thought of this system is that the gold will not actually be required and that in due course there will be a demand for funds in the opposite direction, so that in the majority of cases as a net result no shipment of actual gold will become necessary.

A similar system, *mutatis mutandis*, might well be devised between countries of the American hemisphere. To illustrate: An agreement might be entered into between the National Bank of the Republic of Argentina and the Federal Reserve Bank of New York to the effect that each would be authorized and agree with the other at its convenience to receive gold for account of the other and hold the same as a clearance fund. It is clear that if this gold remained until exchange turned from gold-shipping to gold-importing point the gold so held would ultimately be drawn against and released again without any expense for freight or insurance. Loss of interest could possibly be avoided by permitting the gold deposited to be credited by the creditor bank upon receipt of a properly authenticated cable. It would, of course, be entirely optional with both banks whether to make such deposit and whether to accept it and up to what amount. It is also clear that the Argentine bank in depositing the gold and selling the New York exchange would set aside as a margin of safety and profit the approximate equivalent of shipping expenses, loss of interest, remelting, etc., as well as the charge to be made by the New York bank for safeguarding the gold.

The same basis of calculation would have to be applied if the transaction were reversed. Wherever actual shipments can be avoided and the transaction can be reversed the charges set aside would ultimately become the respective bank's profit instead of being wasted.

A good and valid objection to the plan might be raised by pointing out that the government banks would hardly be considered as acting conservatively in permitting large amounts of their gold to rest in the hands of foreign nations which, conceivably at least, might be involved in war with other nations or even with a nation having made the gold deposit with such enemy country. This objection might, however, be overcome by international agreements to the effect that several nations together would act as trustees for these funds through their authorized agents and that they all together would agree by treaties that these clearance funds should remain the property of the depositing country under all and any circumstances and not be subject to seizure.

To illustrate: We might contemplate in the case of the Argentine and the New York banks that if gold were deposited in New York at the Federal Reserve Bank, the same would be held under joint lock and key by the New York bank and a properly authorized agent of the Argentine government (consul or diplomatic agent), and that if it should be thought advisable a third party acting for the other signatories to such treaty would act as the third trustee.

The undersigned do not wish to be understood as attempting to suggest the details of an agreement of this kind. The object of this memorandum is only to outline in its broadest aspect the thought of a general gold-clearance fund among American nations. The reason for suggesting it at this early time is that if we take a long look ahead it will become readily apparent that such a plan may become of great value to countries having gold coins in circulation which might become interchangeable and circulate as fractions or multiples of the local coins of other American countries.

Between such countries a gold clearing would be carried out to good effect, while this would be much more difficult, if at all practicable, where countries had to deal with gold coins of different fineness and denominations, which, in order to become available for use in other countries, would have to be melted and recoined in case the gold had actually to be shipped. It would lead too far to enumerate these difficulties in greater detail.

Respectfully submitted,

Archibald Kains
Paul M. Warburg

Draft of Convention Providing for the Establishment of an International Gold Clearance Fund Submitted by the Central Executive Council of the International High Commission, 1919[1]

The draft of the convention providing for the establishment of an international gold clearance fund was prepared by the vice president of the council and the Hon. Paul M. Warburg, member of the United States Section of the Commission, in the summer of 1916, being based upon the conclusions of the meeting of the commission held in Buenos Aires in April, 1916. As submitted by the council to the national sections of the commission, the convention has been studied and found acceptable by several of them, and its formal conclusion between some of the American republics is expected soon to take place.

While there is general agreement as to the practical advantages of the system proposed to be established by this convention, its operation and purposes have not everywhere been clearly understood. The council, therefore, wishes to clarify various points which have arisen in the course of discussion.[2]

Convention Concerning an International Gold Clearance Fund

Whereas experience has shown that the payment of debts arising in the course of commercial and financial transactions

[1] This draft was prepared in coöperation with Hon. John Bassett Moore, Vice Chairman of the International High Commission.

[2] Conventions on the basis of this draft were concluded between the United States Department of State and the following governments: Ecuador, Guatemala, Haiti, Panama, Paraguay. The Department of State sent the treaties to the Senate in 1920–21; the Senate failed, under a changed Treasury influence, however, to ratify them, and as a consequence they never went into effect. Peru, Uruguay, and Venezuela were on the point of signing when, after the failure of the Senate to ratify, the Department of State abandoned the negotiations. The governments of four additional republics had accepted the Convention through the International High Commission and were ready to negotiate diplomatically about it.

is often impeded and rendered difficult by reason of circumstances which interfere with and temporarily render impracticable the safe transportation of gold from one country to another, in consequence of which trade is deranged, values are rendered uncertain, and financial loss is incurred, the high contracting parties, being desirous to guard against such grave inconveniences, have decided to conclude a convention for that purpose, and to that end have appointed as their respective plenipotentiaries:

The President of the United States of America,....................

...., and

The President of the Republic of...

....

who, having exhibited to each other their full powers, which were found to be in due form, have agreed upon the following articles:

Article I

With a view to stabilize exchange and facilitate the settlement of balances, the high contracting parties agree that all deposits of gold, made in banks designated for the purposes of this convention within the jurisdiction of either of them for the purpose of paying debts incurred in the jurisdiction of the other, in the course of private commercial and financial transactions, shall be treated by the respective governments as constituting an international fund, to be used for the sole purpose of effecting exchange.

To this end the high contracting parties agree never to appropriate any of the moneys included in such fund; and they furthermore engage, each within its own jurisdiction, to guarantee the fund, in any and all circumstances, in war as well as in peace, against seizure by any public authority as well as against impairment by or as the result of any political action or change whatsoever.

ARTICLE II

The high contracting parties agree to act as trustees of the fund mentioned in the preceding article, and for this purpose each of them will designate a bank within its own jurisdiction to hold any part of the fund there existing as joint custodian with such person or persons or such institution as the high contracting parties may concur in appointing for that purpose; and the high contracting parties further agree to invite other countries, with which either of them may have concluded similar conventions, to appoint representatives to take part in such joint custodianship.

Such joint custodians shall hold the moneys so entrusted to them, as part of the fund, subject to the order of the creditors for whom the fund is held.

ARTICLE III

The details of the practical operations of the fund shall be regulated and determined by agreement between the designated depositary banks, and in order to simplify and facilitate such operations the high contracting parties agree to take into consideration the adoption of a uniform exchange standard, permitting the interchangeability of their gold coins, for which purpose they recommend the adoption of gold coins which shall be either a multiple or a simple fraction of a unit consisting of 0.33437 gram of gold 0.900 fine.

ARTICLE IV

This convention shall be ratified, and the ratifications shall be exchanged at ....

within two years, or sooner if possible.

Each high contracting party reserves the right to denounce this convention at any time, it being, however, stipulated that the convention shall remain in force for one year after notice of termination shall have been given by either high contracting party to the other, and that on the expiration of the term of one year after such notice the said convention shall altogether cease and terminate: Provided, That the guarantee of the fund herein given by each of the high contracting parties shall continue in full force and effect so long as any part of the fund on deposit within its jurisdiction at the date of the termination of this convention shall remain unliquidated.

In testimony whereof the respective plenipotentiaries have signed these articles and have thereunto affixed their seals.

Done in .... copies,

at ....

this ....day of ...., 1919.

[Seal.] ....

[Seal.] ....

MAY 22, 1916

XVIII

NEW OPPORTUNITIES FOR AMERICAN COMMERCE AND INDUSTRY

REMARKS AT THE DINNER OF THE ECONOMIC CLUB OF NEW YORK

WHEN, six weeks ago, I had the honor of addressing the Conference of the International High Commission at Buenos Aires, I told the delegates that I considered myself an "exchange professor" whose most important function, while in foreign countries, was not so much to teach as to learn and then, upon his return, to impart the useful information acquired to his own countrymen.

This is the first opportunity which I have had to perform this mission, and I consider it, therefore, a duty to tell you one of the first and most inspiring impressions I received during my stay in foreign lands. This was at Rio de Janeiro, when our excellent Ambassador, the Honorable Edward Morgan, gave me the startling news that, in South America, after-dinner speeches were not the fashion, and that Brazilians, in this respect as indeed in many others, were a highly advanced and kindly nation, permitting their guests to enjoy their dinner in peace! From that moment on I began to enjoy my trip, and I mention this incident to you because I know it will be an added stimulus to many to start out for the wonderful lands of our southern hemisphere.

I was much relieved to see from to-night's program that I am not listed among the "speakers," but that I am classified only as a "guest of honor." Much as I should have enjoyed the privilege of addressing you at length, the accumulation of work since I returned two weeks ago has been such that, to my great regret, I had to inform your president, when accepting your kind invitation, that it would be quite impossible for me to prepare an address befitting this occasion. I am glad of this opportunity, however, to make a few informal remarks —but not a speech.

Permit me to say, then, how much I appreciate the great honor you have done me in inviting me to-night, how glad I am to meet again my fellow members of this club, and with what pleasure I am looking forward to listening to the addresses to be delivered by your speakers.

The topic "New Opportunities for American Commerce and Industry" is, of course, of profoundest interest to me, particularly in its bearing upon our relations with our sister republics of South and Central America.

In considering this question, we might well ask ourselves: Why is it that these opportunities are new for us? Is it that these countries have changed, that we have changed, or is it that the world about us has changed? The truth of the matter is that most radical upheavals have taken place in all three directions, so drastic, indeed, that economic relations all over the world will have to be readjusted at the end of the War.

The United States, in the beginning of 1914, was moving towards the position of an industrial and financial world power. The advent of the War precipitated this development with unparalleled rapidity and to an unprecedented degree; so that, as a result, our evolution from a mere agricultural and borrowing community into a great agricultural, industrial, and lending power has now been completed.

While our own economic status has thus been strengthened, the wealthiest countries of Europe have been destroying their saving power at the rate of approximately $85,000,000 a day; and while our own economic position as against these other nations has been consolidated by a sum which has been estimated at about two to three billion dollars, their own indebtedness has increased by more than thirty billions. And, unfortunately, this condition continues to grow and nobody can at this time foresee how long the cruel hand of destiny will continue to grind into dust what it has taken generations of human toil and endeavor to create.

When we look into the future we ponder and wonder how these countries will manage to carry the burden under which they have to struggle. While we still hope that the load will not smother them, there is no doubt but that it will absorb so much of their strength that other countries, which in the past have been developed largely by the excess saving power of some of these nations, will, for years to come, find this fountain run dry or at least drastically reduced. That means, generally speaking, that the economic progress of our globe will be retarded for a generation or more, and that those nations will feel it the most that were accustomed to depend upon European funds for the development of their resources and had not proceeded far enough in this development to be able, as we were, to dispense with the assistance afforded by foreign capital.

This thought was borne in on me very vividly in South America. Magnificent countries, resplendent with natural wealth and wonderful opportunities, are now threatened in their progress by a struggle not their own and thousands of miles away. The deep significance of the situation impressed me all the more because of its similarity to the history and the problems of our own country and because I was conscious of the fact that the United States would have been in precisely the same position had this world conflagration taken place some twenty years earlier.

We have to visit these great South American republics in order to realize the strong bond of affinity that exists between them and ourselves, in spite of differences in antecedents and language.

When I spent an afternoon at the country house of a leading

Cabinet minister of one of these republics—a house possessed by the family for generations—when I admired the wonderful old trees, the rooms full of books and art treasures, the walls covered with beautiful pictures of all schools, when I glanced at the old family portraits—and the new ones by Zorn, Sargent, and Boldini—I had the same feeling that an old New England or Pennsylvania or Virginia family mansion will awaken in us, or an old house in Washington Square in New York. Here, indeed, I saw the descendants of the Spanish Pilgrim Fathers! And again, when I studied the histories of these nations and saw their monuments erected to the memory of Bolivar and San Martin, I fully realized that these countries, too, had their Washingtons and their glorious wars of independence and their periods of transformation from colonial dependencies into sovereign republics. They have their race problems, their immigration problems and, like the United States, while reaping the advantages of a democratic form of government, they too have to struggle with the difficulties caused by the premature and indiscriminate granting of equal suffrage to masses at the time not sufficiently educated.

But, gentlemen, visit Uruguay, the republic that, ten years ago, held the record for frequent revolutions, and you will now find that it is the State of Wisconsin of South America, or—perhaps—it out-Wisconsins Wisconsin. You find a most modern, highly progressive administration; government-owned banks, and lighting plants, trams, and hotels owned by the municipality; beautiful universities, splendid agricultural and veterinary schools, and prisons so attractive and modern that I asked to have a cell reserved for myself—in case of need. And as the keen and intelligent men, now in charge of the administration of the country take you through their public buildings, and as you see the wealth and progress of the country, there comes to you the profound conviction that the swamps breeding the mosquito which spreads the infection of revolution are laid dry by the same influences that are the foundation of our own national growth: the influences of education, industry, political equality, and liberty.

I wish that etiquette would permit me to describe to you some of the statesmen we met. I use the word statesmen advisedly, for we found men of the rarest type, courageous and sincere and inspired by the highest ideals.

It would be presumptuous on my part—after so rapid a visit to these vast countries—to attempt to picture to you the indescribable charm of Rio, or the untold and untouched riches of Brazil—a country larger by 269,000 square miles than the United States proper and having a population of only about twenty-three million people—or the endless Argentine plains, teeming with grazing cattle, or Buenos Aires, the city of over a million and a half inhabitants, with New York spirit and Paris taste, or Chile, the California of South America, with its wonderful climate, its virile race, its undeveloped water powers, and mineral wealth.

I can venture only to speak to you in bird's-eye-view terms. But, speaking in these terms and fully conscious of the fact that generalization can never do justice to all the phases it appears to cover, we might say that the wealth of these countries, the lavishness with which nature has treated them, has, to a certain extent, been the cause of their weakness. It has made many of them dependent upon the marketing of a few single staples—be they coffee, rubber, cattle, wheat, nitrates, or guano—it has prevented them from diversifying their industries, from producing at home many a thing that they purchase abroad, and it has made them extravagant instead of teaching them thrift. And again, gentlemen, we need not go very far to find the parallel in our own country.

The present world crisis has taught them—as it has taught us—the necessity of economizing, of importing less extravagantly, and of developing more intensively their own resources and industries. At the same time, it has brought home to them most forcibly the other necessity of never again being found dependent exclusively upon the ships, credit, or good-will of Europe to reach their markets. It is not only a humiliation to the national pride of these nations to be told from whom they may buy in their own countries and to whom they may sell abroad, but their very economic life has been placed in jeopardy by the temporary withdrawal of shipping and banking facilities, and by the extortionate freight rates exacted for what little tonnage has still been left over to take care of their trade. They look to us to remedy a situation which is as unbearable to them as it is to ourselves. They feel themselves at one with us in this respect, for it is for our own protection as well as theirs that the "stars and stripes" must fly over a mercantile fleet large enough to ensure the independence of the trade of this hemisphere! They furthermore trust that our own financial emancipation will be an important factor in securing greater financial independence to them.

I returned from these southern shores with the feeling that North, Central, and South America are one economic unit, not only because nature has made us neighbors, inhabitants of the same great continent, but because our historic traditions, our political ideals, and our economic problems and interests are substantially the same. While they are following in our wake, we are headed for the same goal, and the rocks and cliffs are the same in their course as in ours.

Central and South America and the United States are not competitors; they supplement one another. The more we develop into an industrial nation, the more we ourselves shall consume foodstuffs that we used to export in the past, the more shall we be called upon to import the products of the southern hemisphere and export in return the articles that our manufacturers will supply.

It is but a short time since we began to take an interest in South and Central American affairs. The reason is clear; economically we had not reached the point of development of being an industrial and, from the banking point of view, a lending nation. The consequence was that we were provincial, satisfied with our business opportunities at home, and unwilling to study and adjust ourselves to the habits and thoughts of other nations.

Changed conditions have brought about a different condition of mind. A change of mind on both sides. As Ambassador Stimson put it in a speech at Buenos Aires, we were like fishermen living in adjoining cottages facing the Atlantic, having all the windows towards the ocean, and looking across the sea all the time, with no means to look at each other. We now have broken a window into the adjoining wall; for the first time we begin to know and understand each other, and I, for one, should like to prophesy that, by mutual consent, very soon we shall widen that window rapidly and make it a very large and comfortable door. How that may best be done, others better qualified than I will discuss to-night.

Let me express only these general thoughts: Europe's saving power being crippled while our financial power has grown by her misfortune, there is no doubt that it will be both our opportunity and our duty to assist in developing the resources and industries of those of our sister republics that are still dependent upon foreign credit for the completion of their economic development.

Let us bear in mind, however, that the best business policy is not only the square deal, but the fair deal. Permanent business relations are not established by driving a hard bargain, but by transactions fair and equitable to both parties, and that applies as much to the South and Central American who desires to establish a market for his goods or securities with us as it does to the North American entering these new fields.

Furthermore, in order to perfect the establishment of intimate relations with these nations, we must understand and speak their languages. Confidence is the basis of business.

If we do not understand these people, their methods, or their point of view, we cannot deal with them with that consideration and discrimination to which every human race is entitled. We must be able to discriminate between the good and the bad amongst them, as they must be able to discriminate between us, but, having found the best, we must deal with them on the basis of the same full confidence and equality as we would deal with the very best among ourselves. . . .

I wish that I could impress our business men with the importance of sending abroad only men of experience and high standing, such as enjoy their confidence to a sufficient degree to permit them to discriminate and not be bound by uniform and narrow restrictions. Let us remember that a country is often judged by the first business representatives it sends abroad, and let us, therefore, do all we can to keep away all elements that might do injury to the standing and reputation of our merchants and manufacturers. The United States Chamber of Commerce agreements for the arbitration of business disputes will be important factors in protecting the good name of American business men in foreign lands. Glib talk and speeches will not avail. We shall be judged by our acts.

And, furthermore, while for years to come we shall have a telling advantage in all work of development leading to more or less permanent investment in South and Central America, Europe will bend every effort at the end of the War to regain her full share in the regular commerce of these countries. She will need this trade much more than we do and we shall not be able to secure a fair proportion except by a determined and persistent effort. These markets cannot be conquered by spasmodic outbursts of energy and enthusiasm, but only by unrelenting and well organized work.

Nor can we expect to succeed unless this, our "land of liberty," gives as much freedom to American enterprise—merchant, manufacturer, shipper, or banker—as is enjoyed by our European competitors. Our banks must be as free to go into foreign countries and to finance this foreign trade according to the local usages and requirements as are the European banks, which are practically free from legislative restrictions in this respect. Great headway has already been made during these last two years, and we have reasons to hope that some of the recommendations made by the Federal Reserve Board tending further to increase the scope and efficiency of American banking in foreign countries will be acted upon promptly and favorably by Congress.

A discussion of "New Opportunities for American Commerce and Industry" naturally brings to mind two of the most constructive achievements of our generation—the Federal Reserve Act and the Panama Canal. It is impossible, however, to discuss to-night the important effect of the Federal Reserve System upon the development of our foreign trade and the great progress already made by our banks in these fields, or to describe the thrilling impressions received by all of us during our trip through the Panama Canal, this wonderful piece of engineering which, by cutting apart the North and the South, brought them so much closer together. Let me, in closing, relate to you only one little incident that deeply impressed me at Panama. An American admiral's wife said to me: "I am sorry we have to leave Panama and go home, because it is such a splendid place for my children!" Panama and yellow fever were words almost synonymous in the past; no higher compliment was ever paid American engineering and medical skill than this mother's comment. It is this kind of work—the beginning of which we saw at Haiti and the complete, final success of which we perceived at Havana—that constitutes the highest type of constructive work, a contribution upon which every American may look with just pride.

I hope that American business will make for itself an equally good record. Our South and Central American fellow citizens will then esteem and love us—even though we should carry into their innocent countries the bad habit of after-dinner speeches.

JUNE 9, 1916

XIX

THE FEDERAL RESERVE SYSTEM AND THE BANKS

Address Before New York State Bankers' Association Convention, Atlantic City, N. J.

A SUCCESSFUL solution of Federal Reserve problems is dependent equally upon a thorough understanding of the many features of detail involved in the technique of banking and upon a strong grasp of the big and fundamental objects for the accomplishment of which the System was created.

It is, therefore, a pleasure to address an audience that is certain to have a keen and sympathetic interest in both of these phases of the problem. I am particularly anxious, however, to speak to you about the broader and more fundamental questions involved, for there is an indefinite feeling of apprehension in my mind that at this time we may be losing the large point of view of financial statesmanship, and that petty and technical questions may be claiming, perhaps, too much of our consideration.

While in South America I had an opportunity to get a bird's-eye-view of the operation of the Federal Reserve System. With the keenest enjoyment and pride I saw our System hitting its mark many thousands of miles away, and became deeply impressed that we are now firmly establishing ourselves as a great financial power in the world's markets. Upon my return I felt a very chilling change of atmosphere, when I met American bankers appearing to hold the view that the future of our great monetary and banking system depended upon the question whether or not a country bank might charge exchange of one-tenth of one per cent when remitting for checks drawn on itself!

The banking system of a world power cannot possibly be construed upon so small a foundation.

I still remember that, when I had my first training in banking in Hamburg, thirty years ago, my dear old father's mind strongly rebelled against what he considered then the new-fashioned idea of being required—not by the government, indeed, but by the general law of competition—to discontinue the practice of charging a small commission when remitting for checks or maturing bills drawn on his banking firm. But he soon perceived that the establishment of a general transfer and clearing system, postal orders, and postal checks, had made for new conditions and that the development of a discount system based upon modern principles of banking, while breaking down certain petty revenues, was bringing about a tremendous increase in the volume of business. As a result, he soon waived his objections and lent his hand in turning his country from provincialism into an international banking power. That, as I said, was thirty years ago.

I have no doubt that this country has decided that it is entitled to as modern a banking system as the rest of the world, and that whatever old-fashioned privilege still blocks the path will have to fall by the wayside. The sacrifice will have to be borne for the general good and will find its compensation in the freer economic development of the country.

One of the most tangible results of the operation of the Federal Reserve System is the establishment and growth of the American bankers' acceptance business. In addressing a group of bankers it is unnecessary to dwell at length upon the fundamental importance of this development for the general safety of our banking system. We have now a substantial market for bankers' acceptances to which all member banks will look for the investment of some of their idle means and in which, at any time, they may reconvert these holdings into liquid funds.

The more important this market grows, the stronger will be the position of the Federal reserve banks, for the greater or lesser volume of purchases of such acceptances will offer one of the Federal reserve banks' most effective means of exercising a wholesome influence upon the fluctuation of interest rates. As normal conditions are reëstablished in the world, this acceptance market will become an important factor in protecting our exchange position with foreign countries and, incidentally, our gold holdings. It has taken some time to develop this market, but I am confident that, from now on, its growth will be rapid. One of the obstacles that made the start difficult was found in the fact that many acceptances, which are made for the purpose of financing importations and exportations, have to be drawn and sold in foreign countries.

In order to make them negotiable in those countries as a popular and current means of exchange, it was first necessary to find banks there which would be willing to purchase them freely whenever offered. It is unnecessary to say that European banks operating in these foreign fields were not overanxious to see American bankers enter a business which they themselves monopolized up to the beginning of this war. It is only since our own banks went out into foreign lands and established their own branches that the necessary foreign market for American acceptances has been developed. The establishment of foreign branches of American banks has been a most important step in advance, and without it our acceptance system could not have progressed as far as it has to-day. The advent of these American branches forced the other banks to modify their resistance and to compete for our bills which, up to that time, they had tried to disregard. It is to be hoped that other American banks will soon follow in establishing themselves in foreign countries.

As you know, the Federal Reserve Board has recommended an amendment to the Act to enable national banks, singly or jointly, to hold stock in banks organized "principally to do business in foreign countries." One bill has already passed the House, and another has been reported favorably by the Senate Committee on Banking and Currency. The Board hopes that a satisfactory bill will be agreed upon by both Houses in the very near future.

It is a strange fact, however, that many of our business men, who enjoy the reputation of being keen and progressive, are actually wasting their funds by still using foreign acceptance credits instead of American. At Rio I found to my surprise that the majority of American coffee importers were still using letters of credit in sterling for which they were paying a discount rate of about 4¾ per cent as against the American discount rate of 2 per cent. Moreover, in doing so, they were often paying two commissions, one to the foreign banker who issues, and one to the American banker who opens the credit, instead of paying a single commission to the American banker.

It is true that the wool and hide business, done by New England with the Argentine, is to-day financed by dollar acceptances drawn on Boston and New York, and that the oriental trade has begun to use dollar bills, but it is surprising that so large a number of New York importers are still clinging to their old pound sterling acceptance arrangements.

Let me venture to urge most earnestly that our bankers canvass their lists of importing and exporting firms and point out to them the folly of not using American banking facilities. Since my return I have tried to see personally some of these large importing firms and explain to them the anomaly of their action. I believe, however, that an association like yours is particularly well adapted for carrying on a campaign of education of this kind.

With our increasing financial strength and with the daily diminution of Europe's saving power, it stands to reason that, for a long time to come, our discount rates will compare favorably with those of Europe. We may expect, therefore, that this acceptance business will not only hold its own, but will grow and may be used to a substantial extent even by European importers and exporters, and thus relieve Europe of some of her financial burdens.

While our foreign competitors, with few noteworthy exceptions, are still trying to keep our dollar acceptances in obscurity, our machinery is now firmly organized. There are now local banks almost everywhere abroad willing to buy American drafts going forward for acceptance and to deal in dollar exchange on practically the same narrow margin which prevails in dealings in sterling, marks, or francs, and the Federal reserve banks are willing, whenever desired, to do their share by quoting favorable "forward discount rates" to assure the rate of discount pending the time of transit. This new feature of American banking, which is to be one of the roots of our strength and, at the same time, a new source of profitable and sound banking, ought to be developed energetically by both our bankers and our business men.

In this connection, it may not be amiss to give you a short account of the Conference of the International High Commission at Buenos Aires.

In our deliberations, the question of banking was given particular attention, and I am happy to report that the general tendency at the conference was to do everything possible to foster trade relations between the United States and her neighbors to the south, and mutually to open the doors wide to one another's banks. Resolutions were passed making for the adoption by Central and South America of uniform laws concerning bills of exchange, bills of lading, warehouse receipts, and similar matters. A further recommendation was adopted by the conference urging the respective governments to enact legislation giving the widest possible protection to the sellers of goods.

You are all familiar with the agreements for the arbitration of business disputes made between the United States Chamber of Commerce and the Chamber of Commerce of

Buenos Aires. We may expect that other countries will follow in the very near future, and the creation of these agreements will be an important factor in obviating the annoyance and delay of protracted litigation in foreign countries and in providing for both sides a safe and satisfactory basis for commerce and trade.

It would lead too far to enumerate all the topics discussed by the conference. I should not omit, however, to mention that a resolution was passed recommending that all the republics of North, Central, and South America adopt a uniform standard of money of account on the basis of a gold coin $^9/_{10}$ fine and weighing 0.33437 gramme. This unit, which might be called the Pan American franc, though nearly the value of the European franc, is not its exact equal, but is precisely one-fifth of the United States gold dollar. Delegates to the conference had suggested making the gold dollar of the United States the unit for all American countries, but against this it was pointed out that the dollar would be too large a denomination for many of the southern republics, where small coins circulate and where, it was feared, the larger unit of money of account would bring about an increased cost of living. Moreover, the United States gold dollar could not be divided into subsidiary coins small enough to comply with the known demands of many of these countries. It was thought, therefore, that a unit of the approximate size of the franc would be better adapted to the needs of these countries, but, by adopting as the standard unit the exact one-fifth of the United States dollar, the foundation will have been laid for a Pan American union of coins which, sooner or later, may become of great importance. If this plan should be carried into actual effect, the Pan American 20 franc piece could ultimately circulate with us as a $4 gold piece and our $5 gold piece could circulate as a 25 franc piece in South or Central American countries. A unity of standards of this kind will, of course, have great advantages in facilitating trade between nations. Among republics having actually introduced a gold currency on this basis it might ultimately lead to an understanding for the establishment of international gold trust or clearing funds, having for their object the elimination of the costs and risks caused by our present wasteful method of shipping and remelting gold coins. A plan on these broad lines, submitted by the American delegates, was recommended by the conference for closer study to all governments concerned.

The immediate practical importance of this step may not be great. As indicative of the trend of future relations between North and South American republics, however, it cannot be overestimated. It shows, as one of the effects of the War and of our financial emancipation, that the North and South have recognized their common economic and political interests; that they have begun to consider this large hemisphere as one economic unit, and that they are now looking to each other for mutual help and coöperation in the future development of their respective problems. A Pan American monetary union, therefore, now appears a more natural basis for the future monetary systems of American republics than a Latin union based upon an agreement of France, Italy, Switzerland, and Belgium.

Our friends in South America consider the creation of our Federal Reserve System as one of our greatest achievements, and their willingness to rely upon our ability to provide—to a certain extent at least—such financial aid as Europe gave them in the past is predicated upon the confidence that our new System inspires. Some of these republics are carefully studying this System with a view to establishing, at the proper time, a similar banking machinery. In view of the fact that several of these countries are federations like the United States and cover tremendous areas of territory, it is evident that certain features of our System would be particularly well adapted to their needs.

While observing financial and commercial conditions in these countries, it was deeply impressed upon my mind how much the United States, by legislative action, had in the past handicapped the development of our business in foreign lands. It would lead too far to mention to what extent our own legislation in the past has driven our merchant marine from the ocean and how far it has handicapped our industries by not permitting reasonable trade combinations enabling us to compete in foreign markets. But it is well within the bounds of this address to mention that the British, French, and German banks for generations have been entirely free to go into foreign countries to open branches or acquire foreign banks, and to do everything and anything to further their banking and trade. On the other hand, our national banks, until the passage of the Federal Reserve Act, were forbidden by law to enter these fields or to accept drafts for importations or exportations or to exercise many other functions necessary to develop foreign banking and foreign commerce. It is a relief to feel that at last the time has come when a clear recognition of our country's banking needs is asserting itself and when most of these old shackles have been removed. Whatever obstacle remains we may confidently hope to see gradually eliminated.

Some amendments along these lines are at present under consideration by Congress, and have already been favorably reported.

The Board has recommended that Congress permit member banks to give their acceptances not only for the financing of transactions involving importations and exportations, but also, to a limited degree and under the supervision of the Federal Reserve Board, for bankers' clean three months' drafts, such as are required in foreign countries for remittances abroad. As most of you know, in South America such remittances to foreign lands are generally not made by checks, but by three months' drafts, and it is necessary that national banks be permitted to accept for this kind of foreign exchange transactions, if the dollar bill is to be used as freely in foreign lands as is the sterling, the franc, and the mark exchange.

Turning to amendments touching domestic operations, we have recommended that national banks be permitted to accept drafts or bills growing out of transactions involving the domestic shipment of goods—provided shipping documents are attached at the time of acceptance—and drafts and bills which are secured by warehouse or similar receipts covering readily marketable staples, or by the pledge of goods actually sold. We feel confident that, by enlarging the powers of national banks to accept in this manner, we shall open for our member banks a new and profitable field of operation, and incidentally the free development of this kind of bankers' domestic acceptances will be an important factor in equalizing interest rates in the various parts of the country and will be of great benefit in this respect alike to producer and consumer.

We have also proposed an amendment authorizing any national bank, located in a city of more than 100,000 inhabitants and possessing a capital and surplus of $1,000,000 or more, to establish branches within the corporate limits of its city, and authorizing any national bank located in any other place, with the approval of the Federal Reserve Board, to establish branches within the limits of its county or within a radius of 25 miles of its banking house, irrespective of county lines. In recommending the county line for branches, the Board was moved by the thought that it might be found convenient for several small banks doing business in the same county to combine into one larger bank, thereby reducing the overhead charges and making the deposits of one part of the county available for the demands in another. It is the hope of the Board that in some districts, through such coöperation, it will be possible to reduce the exorbitant interest rates which, in some instances, have been charged by small country banks. The Senate Committee has stipulated that, for the beginning at least, the number of branches of a national bank shall be restricted to ten.

We have further recommended to Congress that any national bank, not situated in a central reserve city, be permitted, within the same limits as now exist for loans on farm lands, to make advances maturing in not over one year on improved real estate located anywhere within a radius of one hundred miles of its place of business. While the Board does not favor the idea of having national banks make heavy investments in mortgages, it was felt that they should not be precluded from taking, within certain reasonable limits, first mortgages as collateral security for their loans.

These are the additional powers that we have recommended to be given to national banks. As to the Federal reserve banks, we have suggested that Congress permit them to make advances to their member banks on the latter's own notes secured by eligible paper, such loans to be for periods not exceeding fifteen days. This has been done with a view to enabling Federal reserve banks to accommodate members who, in the check clearing or otherwise, might be short in their balances and wish to have short advances at moderate rates. We believe that this power, if granted to Federal reserve banks, will greatly increase their ability to take care, in a simple and effective manner, of the requirements of their members, and particularly of country banks.

We have further recommended that Congress permit Federal reserve banks to issue Federal reserve notes, not only against commercial paper, but also against the deposit of gold. This amendment, if granted, would greatly strengthen the lending power and the note-issuing power of Federal reserve banks. It is the same method that has been followed in Europe by the Banque de France, the Reichsbank, the Bank of the Netherlands, the Bank of Italy, and many other government banks. These institutions are enabled, through their note issue, to assemble a large part of the gold of the country in a central reservoir. With us, up to the present time, this accumulation of gold has taken place to only a moderate extent and has not benefited the Federal reserve banks to the fullest possible degree. If the amendment were to be passed, the gold, instead of being segregated with the Federal reserve agent, would remain an asset of the Federal reserve bank, and, on the other hand, the notes issued against it, instead of being, as at present, technically redeemed, would remain the liability of the Federal reserve bank.

In case the amendment should pass, it is hoped that the Federal reserve banks may count upon the coöperation of their members in order to facilitate this substitution of Federal reserve notes for gold certificates at present carried in the pockets of the people in the old-fashioned and uneconomic manner. As in modern European countries, the gold should accumulate in the Federal reserve banks and the people should use instead the Federal reserve notes. The amendment would be an important step in the direction of the ultimate simplification and consolidation of our circulation.

These are the principal amendments recommended by the Board at this time. You will notice, gentlemen, that they move in two directions. The one is an increase of the reserve banks' general strength and lending power and an enlargement of their scope of usefulness in dealing with their members; the other is the removal of limitations heretofore placed upon the operations of national banks.

The Board feels keenly that, as a matter of equity, national banks should be placed on a parity with state banks and trust companies, wherever this can be done consistently with safety and conservative banking principles. But I wish to make it clear that the Board has recommended, and will recommend, only such measures as will eliminate old-fashioned or unwise restrictions such as should be removed under any circumstances, irrespective of whether or not the state banks exercise greater or lesser powers. The Board would never recommend granting national banks any powers or privileges which are contrary to good banking principles. It is to the interest of both state institutions and national banks that banking standards should be raised wherever practicable and not that they should be lowered. Between the national and state banking systems there must not be any competition to secure more members by a lowering of banking standards. The whole country would suffer if this took place. It would be the height of folly if States were to lower their requirements for no other reason than to underbid the requirements of national banks. To a certain degree this has been done—where State governments lowered the reserve requirements for their banking institutions because the Federal Reserve Act lowered the reserve requirements for national banks. The lowering of the reserve requirements for national banks was predicated, however, upon their joining the Federal Reserve System, subscribing to the stock, and putting some part of their reserves into the joint insurance fund, and being bound ultimately to abandon the method of pyramiding reserves and to keep them instead either entirely in metallic form or with the Federal reserve banks. The reserves of state institutions, on the other hand, were lowered without their being required to join the System, make any such contribution, or discontinue pyramiding reserves. Moreover, lower reserve requirements are justified for member banks because they may have direct recourse to the rediscount facilities of the Reserve System, but non-member banks have no such direct access.

I wish I could adequately impress upon the minds of all our bankers that there is no such thing as doing anything *for* the Federal Reserve System. Whatever the member banks do, and whatever the state banks do, they do for themselves and for the country. The Federal Reserve System, as such, is not a self-seeking and profit-making organization. It belongs to the entire country. It is there for the benefit of everybody; for the greater security of the banks, and, through the banks, for the security of the people. If you strengthen the Federal Reserve System, you strengthen yourselves. If you raise the standard of banking, it is for your own benefit —not for the benefit of the Federal reserve banks, or least of all, for that of the Federal Reserve Board.

These things appear trite, but still I cannot help expressing them because it is so absolutely essential that the thought be overcome that there can be such a thing as a conflict of interests between the Federal Reserve System and the banks. The Federal Reserve System and all it means is felt as an opposing factor where it comes into conflict with bad banking practices. It is true that the law has as one of its objects the removal of certain habits which have crept into the old banking system, but it is equally true that, by removing them, financial catastrophes such as used to befall our country with uncanny regularity, are to be avoided in the future.

Let us consider, as the strongest case in point, the pyramiding of reserves. I wish it had been possible to stamp out this evil within a short time after the opening of the Federal Reserve System. As it is, many of the smaller banks are still in the condition of a patient who knows that he must undergo an operation in order to be fully cured, but whose mind every now and then rebels at the thought, and who continually relapses into arguing with himself that, after all, he might possibly prefer to continue to live with his disease and take his chances of the certain recurrence of acute convulsions and intense suffering rather than to have the operation performed. The country, however, has decided that the operation is necessary for our future safety and growth, and the vast majority of our bankers are in full accord that it is the wisest thing to do. The pyramiding of reserves will thus end on November 16th, 1917. But, as I said, I wish the operation had already been performed.

At present our national banks apparently have excess reserves approaching one billion dollars. Of these, a substantial proportion represents items in transit between the depositing and the depositary banks; the balance, excepting about $100,000,000 excess cash in vault held by all national banks outside of New York, is kept entirely in central reserve cities, the bulk being in the City of New York. There it is on deposit—drawing interest at the rate of 2 per cent—and loaned out on stock-exchange and other collateral, or invested in commercial paper, except as to the required reserve of 18 per cent and the small total excess reserve of about fifty million dollars. This is a reduction of excess cash reserves in New York of over $100,000,000 since January 22nd.

If Farmer Jones deposits $1,000 in a bank of Elk River, Minnesota, and this bank should in turn deposit this amount in a bank at Minneapolis, and the Minneapolis bank in turn deposit it in New York at 2 per cent interest, and New York invest this money in a piece of commercial paper at 3 per cent interest, it is a most extraordinary and unique method to permit Elk River and Minneapolis to count these deposits as reserves, while if the bank of Elk River had itself bought the piece of paper it would have carried it as a loan and all the rest of the structure of reserve bank deposits and reserves would have been wiped out.

In other words, in the final analysis, if we consider the System as a unit, there is not an excess reserve of one billion, but only about $150,000,000 in cash; the balance is invested to-day in the "float," representing uncollected items in transit, commercial paper, stock-exchange loans, and securities. If we study the changes in the condition of the New York Clearing House national banks which have occurred between October 31st, 1914, and May 1st, 1916, we find that while their unsecured loans, largely composed of customers' notes and other commercial paper, increased during that period by over 260 millions, their investments increased by nearly 175 millions, and their collateral loans—by over 300 millions, as shown in the following table:

(In millions of dollars)

	Oct. 31, 1914	May 11, 1916	Increase
Collateral loans	547	954	407
Investments in securities	106	280	174
Unsecured loans, which includes commercial paper	406	667	261
Total	1,059	1,901	842
During that period deposits increased from	1,200	2,100	900

In addition, collateral loans and holdings of securities of New York non-member trust companies increased by about half a billion since the end of 1914.

These are phenomenal increases and we might well ask ourselves whether or not we may take it as a certainty that so extraordinary a growth will prove to have come to stay or whether a return of more nearly normal conditions will not bring about a contraction. We should well consider this question, because an increase of 90 per cent in securities and collateral loans—that is, an increase of over $1,000,000,000 in New York City Clearing House institutions—might well suggest a policy of liquidation rather than one of further expansion. Our national bank *cash* reserves in central reserve cities (including balances with Federal reserve banks, figured at 100 per cent) were as of March 7th, 22.88 per cent; in reserve cities, 11.53 per cent, and in country banks, 9.80 per cent.[1] Notwithstanding that the aggregate cash held by all national banks increased from May, 1915, to March, 1916, by over $100,000,000, in central reserve cities we are to-day materially below the old cash reserve requirements, and if a situation like the present had existed during any ante-Federal Reserve

[1] If we figured these balances at 70 per cent, being the present cash reserve condition, and the actual metallic reserve, and added to cash in vault the metallic cover maintained against reserve agents' balances, the present cash cover would show as follows: Central reserve cities, 20.51 per cent; reserve cities, 13.66 per cent; and country banks, 11.83 per cent.

System period, we should have considered it a cause for alarm. Thanks to the creation of our new banking system, we are now dealing with completely changed conditions, and the spectre of the end of the lending power of the banks would not mean a panic as in the past because of the reserve lending power of the Federal reserve banks and the confidence created by their existence. But, gentlemen, that must not lead us into the illusion that this billion of so-called excess reserves may be considered as a basis for a loan expansion of four billion dollars or more, as appears to be the general belief. Theoretically there is the foundation for so large an expansion as long as we adhere to the old custom of counting bank balances with reserve agents and uncollected items in transit as reserve, yet, in the last analysis, it is the metallic cover—not the redeposited and actually invested reserves—which must be considered in dealing with this question of expansion of loans. *The excess of our metallic reserve, plus the free gold of the Federal reserve banks, constitute the basis of the reserve lending power of our country.*

We are at present in a condition of extraordinary strength. We have bought back our own securities and made foreign loans to an aggregate amount far in excess of $2,000,000,000. Our financial position for the future has thus been greatly fortified. *But the process of absorption of our securities returning from abroad should be conducted on such a basis and scope as to turn the individual depositor into an investor, so as to free our gold reserves, rather than increase our loans on an enlarged floating supply of securities.*

We must not forget for a moment that not even the most experienced can foretell what demands may be made upon us in the future. At the end of the War our opportunities will be gigantic, but ultimately they will be limited by the extent to which we are able to control our gold. There cannot be any doubt that the demand for gold at that time will be very keen and determined. Wise statesmanship, to my mind, therefore, would indicate that everything should be done by the Federal Reserve System and by all the banks that are interested in our strength to watch carefully further expansion at this time and to accumulate the floating gold supply in the hands of the Federal reserve banks so as to enable them, when the time comes, if necessary, to spare large amounts without thereby crippling their lending power. We are in a period of widespread prosperity at this time and it must be our serious concern not to weaken its solid foundation. The ease of this summer might well be used to strengthen and prepare ourselves for the large problems that may be in store for us.

It is impossible to try to prognosticate with any degree of certainty what will be the trend of interest rates at the end of the War, but assuming that interest rates for investments in Europe will be high, and that the demand for gold on the part of Europe will be keen, we would have to expect as a consequence that eventually our rates will have to move up so as to approach theirs more closely, and before we reach that point probably a substantial amount of our gold will have to leave the country and return to foreign lands. To preserve the advantage of our strength and to maintain our money rates on an independent basis of our own—in spite of the close interrelation that must exist between us and Europe—will be one of our interesting but difficult tasks.

The establishment of the Federal Reserve System has been a step of inestimable value in the direction of efficient control of our country's gold holdings; and, if we do not disregard all rules of business conservatism and prudence, it will prove an efficient means of protection in case of emergencies.

If we want more than a strong instrument of defense and protection, if we desire—as we are entitled to—that the Federal Reserve System be the foundation of a banking structure contributing its full share in rebuilding the world and at the same time assisting our own country to meet all the new demands, whether domestic or foreign, that the future may make upon it, then we must do all we can to preserve its strength and to broaden its foundation by further perfecting methods of systematically accumulating and economically using our vast treasure of gold. Too large a proportion of this gold still remains wastefully scattered and decentralized.

The gold stock of this country is estimated at $2,320,000,000. Of this amount, only $335,000,000 is held in the vaults of the Federal reserve banks and about $180,000,000 is in the hands of the Federal reserve agents. The national banks and state institutions hold about $800,000,000, and there is estimated to be in actual circulation about $870,000,000. If we deduct from the $335,000,000 held by all Federal reserve banks a minimum reserve of only 40 per cent, that would leave as their free gold about $200,000,000. This is an invaluable item of strength as a basis for a note issue of $500,000,000 in case additional currency should be demanded by our people; and the Board, by permitting a reduction of the 40 per cent gold reserve, could, in case of emergency, sanction the issue of even larger amounts. When, however, it comes to exportations of gold, you can readily see that the $180,000,000 now accumulated with the Federal reserve agents would serve as a very welcome additional protection. For we have learned, gentlemen, that this is a period of economic history, where balances between nations are not dealt with in millions, but in hundreds of millions.

Think of the strength that our System might possess if we carried into effect the policies pursued by the Banque de France, the Reichsbank, or other powerful central banks, and if, for a substantial part of the $870,000,000 of actual gold circulation, there were substituted our Federal reserve notes, and if national and state banks kept in their vaults only what they needed for till money and deposited with the Federal reserve banks the rest of their idle gold.

We talk of preparedness as the need of the hour. If we contemplate what European nations have done, before and during the War, to strengthen their grip on their gold, and compare it with our own efforts, we find that our financial preparedness is just in its first stages. The amendment recommended by the Board should prove an important step in advance in this direction.

In view of the statement made by some of our critics that this substitution of Federal reserve notes for gold certificates means inflation, it might be timely to point out that, by a simple substitution of one note for the other, there is, of course, no increase in the volume of circulation whatsoever. It is merely a change in the form of circulation. As a matter of fact, we find that the operation of all Federal reserve banks during a period of one and a half years has caused a net increase in the circulating medium of the country, by the issue of Federal reserve notes and Federal reserve bank notes, of less than $10,000,000. On the other hand, the national bank circulation decreased during the period from November 2nd, 1914, to June 1st, 1916, by $53,000,000, exclusive of the redemption of the approximately $385,000,000 of emergency currency issued under the so-called Aldrich-Vreeland Act. While it is evident, therefore, that the Federal Reserve System has not increased the volume of circulation, the process of substituting, as a means of circulation, the Federal reserve note for the gold certificate has the most important effect of strengthening the potential lending and note-issuing power of Federal reserve banks in case of need. To refuse this larger power of protection for fear that it might be misused would be tantamount to refusing to give a modern revolver to a policeman for fear that he might shoot at the wrong man and at the wrong time.

But, let me ask you, gentlemen, is this the proper time for country bankers to urge us to recommend to Congress the further reduction of their reserve requirements or to recommend that they be granted permission to continue to hold a certain percentage of their reserves with their central or reserve city correspondents?

Some day, no doubt, it will be proper to reduce reserve requirements, but that can only be brought about by a systematic strengthening of the central reservoirs. The stronger the Federal reserve banks, the easier the access to their resources by sale of liquid paper, the less will become the necessity for member banks to maintain in their own vaults, as a legal requirement, large segregated gold holdings.

Steps in this direction are: First, the substitution of Federal reserve notes for the gold circulation in the pockets of the people; second, the maintenance with Federal reserve banks of larger member bank balances, created by depositing part of the "optional" now kept in vault by member banks, and, finally, the increase of the number of depositors to be secured through the entrance of the state institutions into our System.

I want to compliment our large member trust companies and state banks upon the broad point of view which guided them when entering the System; but I might at the same time ask their powerful sister institutions how, under present conditions, they can justify themselves in staying out of the System and in throwing the entire responsibility and burden upon the shoulders of the national banks and those few trust companies and state banks that have become members? They do not contribute their fair share of gold to the general reserve fund of the nation, nor do they provide their share of the capital of the Federal reserve banks. Indeed, not only do they fail to contribute their share of strength to the System, but, unconsciously perhaps, they become forces that make for the direct weakening of its strength and efficiency.

Do the large trust companies and state banks claim that pyramiding of reserves is sound? Would they prefer to see our ancient system perpetuated and the reforms contemplated by the Federal Reserve Act abandoned so as to make room again for the good old conditions of 1893 and 1907? Unless they are willing to subscribe to that doctrine, how can these large banking institutions, some located in central reserve cities, justify themselves in considering as reserve, after the manner of the country banks, their interest-bearing deposits with other banks?

If a call loan on the stock exchange made by a trust company is not a reserve but a loan, is it sound banking to call a reserve deposit made by a trust company in a national bank a reserve, when 82 per cent of it is loan on call on the stock exchange? Still, it is just through these deposits that, in emergencies, the trust companies will lean on the national banks and the national banks, in turn, will fall back on the Federal Reserve System. The net result is that the trust companies, in building up their business structure, must rely to-day on the greater assurance provided by the Federal Reserve System, though permitting the member banks to carry the entire burden of its support. Our small country banks will have to stop the pyramiding of reserves; do the large trust companies and state banks plan to continue this practice?

What is it that powerful and prominent institutions (some of which, in their foreign and acceptance business, derive the greatest possible advantage from the discount market and the general prestige of the Federal Reserve System) may say in justification of such an attitude?

At first they feared that, by entering the System, they might lose some of their present powers and privileges. But the Board has made regulations permitting them to continue to exercise practically all legitimate banking functions enjoyed by them in the past.

Some of the state institutions have raised the point that, by joining the Federal Reserve System, they would be called upon to make investments in the stock of the Federal reserve banks upon which, in the case of most of the Federal reserve banks, no return has as yet been paid.

But, gentlemen, while for many reasons some of us would favor an amendment permitting a Federal reserve bank to pay back a portion of the capital paid in (leaving the liability upon the subscribed but unpaid capital otherwise unchanged), provided the member would in turn agree to increase its required reserve balance by a certain proportion of its optional balance, this question in itself cannot possibly be of sufficient importance to keep any strong state institution out of the System. These dividends are cumulative, and anybody having a moderate degree of foresight can readily appreciate that, sooner or later, the back dividends will all be paid. Even at the present low rate of return of 2.4 per cent, secured by Federal reserve banks from their investments, they would have to employ only an additional sum of less than $50,000,000 for the entire System to earn the full six per cent on the stock at present paid in. When the final installment of reserves has been transferred and with the return of more nearly normal rates of interest, there will not be the least difficulty for these banks to earn their dividends without investing a larger proportion of their resources than would be consistent with safety and conservatism.

State banks and trust companies furthermore claimed that if they entered they could not withdraw. But the Board, in the exercise of its power to prescribe regulations as a condition of membership, has provided that they may withdraw under conditions previously made known, and the subscription to the stock of a Federal reserve bank made by a state institution is conditioned upon this express agreement.

They have objected to being examined both by their own banking department and by the examiner of the Comptroller of the Currency. The Board, in accordance with the provisions of the Federal Reserve Act, has provided, however, that, wherever there is an efficient state examination, as in New York, it shall be accepted in place of examination by the Comptroller and, only failing that, an examination shall be made by examiners under the supervision of the Federal Reserve Board.

Furthermore, in a circular letter sent to all state member banks in May of this year, the Board and the Comptroller of the Currency announced that state member banks, in making their stated reports to the Comptroller of the Currency, might use the form of statement prescribed by their respective State banking departments, provided they are rendered as of the same date as required by the Comptroller of the Currency for national banks. If reports are not rendered on those dates, state member banks are required to use the same forms as national banks, but they may omit from their reports to the Comptroller all schedules except that relating to coin or coin certificates.

They have feared that the Clayton Act would deprive them of valuable directors. But Congress has amended that Act so as to permit a director of a member bank to be at the same time a director of two other banks or trust companies, provided they are not in "substantial competition" with the member bank.

I know the arguments that are being advanced that the rulings of the Board may be changed and that, therefore, it may be possible, under a different personnel of the Board, to reverse the present arrangement and subject the state banks to the examinations, reports, and rulings of the Comptroller of the Currency. But that is not likely to happen, and if it did, the state bank or trust company could exercise its privilege to withdraw from membership in the System.

Let us assume, however, that joining the Federal Reserve System does involve certain sacrifices, some of which are necessary and some of which may be thought unnecessary. If you throw on one side of the scales all the benefits accruing to the banks and the nation by the creation of the Federal Reserve System, and on the other the sacrifices to be made by its members, there cannot be any doubt whatsoever that the advantages will outweigh the disadvantages a thousand-fold. The Federal Reserve Act is one of the most constructive pieces of legislation that ever was put upon our statute books. Nobody could be foolish enough to expect that a law which is so complicated in its nature, so far-reaching in its scope, and a compromise in so many details between opposing views, could be absolutely perfect. It is a wonder that, from the beginning, it has proved as workable as it has.

Personally, I am on record as having opposed several of its features of detail. But, when the President honored me by inviting me to become a member of the Board, I accepted because I felt that the fundamental principles were sound and that the Act, as it stood, would redound to the greatest benefit of the country. I felt confident that if after sincere and unbiased efforts in the operation of the reserve banks, defects should develop that needed correction, we could confidently count on a patient and sympathetic hearing before Congress. And let me remind you, gentlemen, that several of my colleagues and the able men who accepted to serve at the head of your Federal Reserve Bank of New York, all joined in the same spirit; they did so for the purpose of serving their country even though they had to make material sacrifices in doing so.

In one of his admirable speeches, entitled "Ideals and Doubts," Oliver Wendell Holmes, Associate Justice of the Supreme Court of the United States, makes the following statement concerning the topic of legal reform:

> To know what you want and why you think that such a measure will help it is the first but by no means the last step towards intelligent legal reform. The other and more difficult one is to realize what you must give up to get it, and to consider whether you are ready to pay the price.

These are golden words of wisdom which, at the present juncture of our economic history, every bank president in the United States ought to have constantly before his eyes.

For generations we have lived shackled and constantly menaced by a defective and old-fashioned banking system; for years we have toiled to secure reform. We have at last brought it about and, whether or not it pleases everybody in every detail, it behooves us all to do our share in making it a success for the greatest possible benefit of our country, no matter whether it involves some small or even a heavy sacrifice. That is the principle which members of the Board have laid down for themselves, and if they are to be faithful to their trust and successful in their task, there is no other principle upon which they can deal with the banks of the country.

That is why, though sincerely appreciating the hardship it entails for the country banker, and fully sympathizing with the difficulties of his position, we must say to him: "Forget these exchange charges. We think our new clearing plan is fair and equitable, free from unsound principles and bound to become a very effective instrument for the general good. It offers to take from you at par all your checks on any member bank of the entire United States, and on certain state banks in addition, and will refund you any actual expense that you may incur in case you have to remit currency. All it asks of you in return is that you remit without charge to your Federal reserve bank in payment of checks drawn on yourself. But even if we did not believe that by the service we render and by relieving you of the necessity of maintaining bank balances all over the country we shall compensate you for what you think will be your loss, we have to hold to the view that you must pay the price—whatever your little share may be—for the larger benefit of all."

The new System brings new opportunities; as an illustration, let me remind the country banker that his exchange loss will appear to him very unimportant if he will adopt the habit of paying for his deposits a fluctuating rate of interest, which should always continue a certain percentage below the ninety-day discount rate of his Federal reserve bank. The unreasonable rates paid for deposit money are a serious menace to the safety of our banking system and the economic development of our country.

And, in this same spirit, and even with greater emphasis, we must say to the state banks and trust companies:

At this momentous period of its financial history, the country is entitled to have its banking system attain its maximum strength. Irrespective of burdens involved—imaginary or real—it is the duty especially of these large state institutions to come in promptly and contribute their share, making whatever suggestions they think helpful as friends and members rather than as critics from the outside.

I am glad to state that one of our largest trust companies expressed precisely this broad point of view when applying for membership.

The Federal Reserve System will grow stronger with every coming day, and the stronger it grows and the more it perfects its organization, the more apparent will its benefits become for all its members. A great deal of pressure has been brought to bear upon the Federal Reserve Board, particularly during the early stages of the development of American bankers' acceptances, to apply discrimination against the acceptances of non-member banks. So far the Board has been disinclined to favor such a policy, as it was thought to be in the general interests of the country to give encouragement to the freest and fullest development of this acceptance business, which is of the greatest benefit to the trade of our country. The Board thought further that time should be given to the state banks and trust companies to acquaint themselves fully with the policies to be pursued both in dealing with state institutions in general and the acceptance business in particular. Nor does the collection plan just approved by the Federal Reserve Board contain any element of discrimination against non-member state banks collecting at par, without cost, their out-of-town checks through member banks of the System. The Board believes, however, that the time has now come for these large institutions to recognize their duty to join the System. It will not be long before the banks that stay out of the System will become conscious of the fact that member banks will command the greater confidence, and there is no doubt that the public will begin to resent having its interests sacrificed for the benefit of institutions unwilling to join the general protective system, and that before long their resentment will have to be heeded.

Before closing, I should like to make it clear that, though speaking to the New York State Bankers' Association, whatever I have said is meant to apply to the state institutions of the entire country. I should not wish to give the impression that I am particularly critical of the New York institutions. Quite the contrary, I am very glad to have this opportunity of testifying publicly to the spirit of good citizenship that you have manifested in every phase of the development of the System from the very beginning, when we were dealing with the gold and cotton funds in the fall of 1914. In the negotiations, resulting in the creation of these two funds, there asserted itself for the first time in our financial history a broad national spirit uniting in a work of patriotic coöperation national banks, state banks, and trust companies of every section of the country. That was the first effect of the coming of the Federal Reserve System, the physical organization of which at that time had not even been completed. It is this same spirit, this larger conception of banking functions and ideals, that will ultimately lead into the Federal Reserve System all elements worth having; that is, all elements of financial and moral strength.

I trust that my frankness will not be misunderstood by you. There is an old adage that "imitation is the sincerest form of flattery." I venture to paraphrase this saying into: "frankness is the sincerest form of flattery," because it shows that you respect the intelligence and moral fibre of your audience.

I believe that our future looms large beyond measure;

I believe it our duty to be financially prepared on the broadest possible scale;

I believe that we should use the months ahead of us, not to expand any further, but rather to consolidate our strength;

I believe that, through the Federal reserve banks, we should strengthen our hold on the gold in circulation and that the stronger the gold holdings of these banks, the better shall we be equipped to cope with the problems ahead of us, of helping ourselves and of helping the world;

I believe it to be the duty of every bank in the country to contribute its share in equipping our nation for this task;

I believe that state institutions which are strong enough should come in now and do their share, no matter whether or not they are in full accord with every detail of the Federal Reserve machinery;

I believe that, as we proceed and gain in experience, whatever may prove harmful will be remedied. The tendency of the country is for a fair deal for fair people;

While I believe that the country expects that strong state institutions should do their duty and join, we are neither begging nor clubbing anybody to come in nor to stay in;

But I firmly believe that the future will belong to those banks—national or state—which are members of the Federal Reserve System.

SEPTEMBER 29, 1916

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THE RESERVE PROBLEM AND THE FUTURE OF THE FEDERAL RESERVE SYSTEM

Address Before the Convention of the American Bankers' Association at Kansas City, Mo.

IT has been suggested that I address you upon the subject of "The Future of the Federal Reserve System." To venture to predict the future is always a risky undertaking and I, for one, dislike to attempt the rôle of prophet. But if our new banking system is to attain its fullest measure of success, we must have in our minds a very definite ideal, a clear conception of the goal towards which we are striving, so that each consecutive step may be a consistent move in that direction. I deem it, therefore, a privilege to be afforded this opportunity of addressing the leading association of American bankers upon a topic in which its members are so keenly and vitally interested, and which—if we are to achieve the most fruitful results—should be solved by their own efforts rather than by legislative initiative.

The well known British writer, Mr. Hartley Withers, in his new book, *International Finance*, makes the following statement: "London's credit machinery has grown up in almost complete freedom from legislation, and it has consequently been able to grow without let or hindrance along the lines that expediency and convenience have shown to be most practical and useful."

When I read this paragraph there came to me again the feeling of regret that American banking had not developed in a similar manner; that—owing to reasons which it is unnecessary to review here—our banking methods had proceeded along lines that had proved disastrous, and that multiplicity of banks, diversity of interests, and divergence of views precluded any possibility of voluntary agreement concerning the adoption of uniform, scientific, and adequate modern banking methods. That failure rendered necessary banking under government regulation and, to a certain extent, in the Federal Reserve Act, even under compulsion. By many this method has been viewed with regret, but unfortunately there appeared no other possibility of success.

I believe it is safe to say that, in general, those laws have proved the best, which put into legal form existing usages already recognized by actual experience as sound both in principle and practice. With us, it was impossible to use existing banking habits as the basis for our legislation. It was necessary to take those banking practices that had proved their worth in other countries and to adopt them as our model, with such adaptations as our own conditions rendered necessary.

It is a most difficult task, however, to remodel fundamentally the structure of a fully developed organization and to do it while the machinery is kept going at top speed. It is evident that it cannot be accomplished without some temporary inconvenience and that it must be done step by step. The tracks in the new depot of the New York Central Railroad in New York had to be moved many hundred times in order to keep the trains running while the larger basis of operation was being perfected.

I am profoundly convinced that the Federal Reserve Act will prove one of the most constructive contributions ever made by Congress, and that the further the System develops, the more apparent will this become.

But, in expressing my unbounded confidence in the future of the System, I am fully conscious of the fact that in its present form it is not a finality, but a beginning. The tracks will have to be shifted many a time and, as the fields opened by the new organization are developed, substantial changes in machinery will have to be made in order to cope with new demands.

Indeed, the Federal Reserve Act would prove a failure if these changes in the System did not become necessary from time to time. In this process of developing the new machinery to its fullest degree of usefulness the bankers of the United States will have to play the most prominent part, and it is for this reason that I am particularly anxious that we should all reach a clear understanding about the future course of American banking, its hopes and its fears. Only if we take this more comprehensive view shall we be able to plan wisely—not for the morrow, not for single interests, but for the larger future and the benefit of all.

I have no doubt that your Association is in harmony with these views and that, in coöperating along these lines, it will prove a most important and helpful factor in the simultaneous evolution of good banking practice and good banking legislation. The natural development will be that Congress will call upon the Federal Reserve Board more and more to act as an expert body in questions of banking—though, unfortunately, this does not mean that our advice will always be heeded. Our conferences with your committees will assist us in the future, as they have in the past, to do our duty fairly in administering the Federal Reserve System and in planning for its future growth.

Let us try to review as briefly as possible the main features adopted from European banking, and to establish where we stopped half-way and what still remains to be done. Time will not permit me to cover each of the various phases involved, but it may be possible to deal fairly comprehensively with the topic of reserves, which, after all, is to many the most puzzling and to all the most vital question involved in the problem.

In 1910 I published a tentative plan entitled "A United

Reserve Bank of the United States." Later on, Senator Aldrich called the system that he proposed, "A National *Reserve* Association"; and finally the Owen-Glass committees devised the "Federal *Reserve* System," which was enacted into law. The word "reserve" has been embodied in all these varying names, and this is significant because the adoption of the principle of coöperative reserves is the characteristic feature of each of these plans.

"Monetary and banking reform" took its greatest step forward when public opinion recognized that it was not essentially a question of note issues but one of reserves. But, though this reserve problem has thus been before us for many years, it is a strange fact that there still exists a singular confusion in the minds of bankers, writers, and students as to what the word "reserve" actually means in this connection.

There are all kinds of reserves. There are military and naval reserves. We speak of reserves in dealing with water supply, with food, raw materials, rolling stock, electric power, and what not. In each case its meaning depends upon the requirements of the organization maintaining the reserve. Reserve is, as the name implies, what one holds back. It generally means an extra supply of something kept idle for the purpose of being immediately available to take care of an increased demand in excess of normal requirements. Now, if we wish to get a clear conception of the meaning of reserves in connection with the Federal Reserve System, we must understand that it is necessary to recognize central banks as entirely different organizations from the commercial banks and trust companies and, consequently, that their respective reserves differ as much as those of an ice factory and a summer hotel—the one a producer and the other a consumer of ice.

Reserves of central banks and reserves of the commercial stock banks are two entirely different things.

For the sake of greater simplicity I shall in this address call the national banks, state banks, and trust companies, the "stock banks" and their reserves "banking reserves," and I shall term the reserves of the central banks "gold reserves," leaving it open at this point whether or not these latter reserves should include silver and greenbacks.

The Federal Reserve System is a coördination of twelve central banks and the same principle as to reserves, therefore, applies as if we were dealing with one central bank. I shall, therefore, in this address, class the Federal Reserve System with the central banks.

Let us consider first the functions of the stock banks in central-bank countries.

Deposit banking is the art of wisely employing the depositors' stored-up purchasing power. It is based on the principle that there is a sufficient variety of conditions among the depositors and borrowers of a bank so as normally to preclude the probability of the depositors withdrawing and using their own money faster than it can be collected from the borrowers to whom the depositors' purchasing power temporarily has been transferred. The bank's own capital and the uninvested part of its deposits form the insurance—or reserve—fund to act as an equalizer in balancing these scales. It is essentially a question of exchanging credits and, where there is a central banking machinery enabling the stock banks to liquidate a sufficient amount of their assets to make good any deficits that may occur, the whole system is safe and complete. The central banking organization provides the member banks either with balances to be used in the clearing, or, if currency should be required, with notes which will be accepted by their depositors in settlement of the stock banks' obligations.

In countries where these notes of the central banks are generally accepted in settlement of debts by business men and banks, the "banking reserves" of the stock banks may safely consist of the central bank currency or of a balance kept with the central bank convertible into such currency. These form the first line of banking reserves. The second line consists of those assets which, with certainty and promptness, may be converted into credit balances with the central bank. It is simply a question of having a reserve of such credit currency, or of power to produce such credit balances, as will provide an acceptable means of satisfying depositors.

Balances with the central bank, and its notes, entitle the stock banks, like any other holder, to payment in legal tender; and if legal tender is demanded by creditors of the stock banks, the latter must rely upon the central bank to furnish it. The duty to keep its own deposit and note obligations sufficiently protected by a proper proportion of metallic cover rests with the central bank, and its reserves, therefore, must consist exclusively of the metal in which its obligations are payable.

In central-bank countries there does not exist any law that requires stock banks to keep in actual specie in their own vaults a certain proportion of their deposits. All the central bank usually requires is that the stock banks and other firms maintain with it free balances commensurate with the scope of their transactions. As a matter of fact, if we study the statements of European stock banks we find one single cash item which includes the combined holdings of gold, silver, bank notes, and the balance with the central bank.

I still remember that when I had my initiation into banking in Europe, twenty-eight years ago, we never bothered much about our cash in vault. We never had more than we needed as till money. If we accumulated too much, we sent it to the central bank to be credited to our account. If we ran short, we sent over to the central bank and got what currency we required. The cash item was of very little interest to us, but we watched continually the balance with the central bank and if our balance approached the prescribed minimum, we would strengthen it by sending over for discount some short paper maturing within five, ten, or fifteen days—or if demands were extraordinarily heavy and unexpected, we might have to send over paper of longer maturity. Or, at times, when the discount rate of the central bank was higher than the ruling rate of the stock banks, the latter would take our short paper —just as we would make short loans to them when we had surplus funds to lend. If conditions became such that the stock banks were crowded so that the central bank would notice that the maturities it was discounting were gradually becoming longer, the central bank would have to consider whether or not it was time for it to raise its rate. If the increased demand was due to seasonal requirements, the central bank would maintain its rate and go deeper into its reserves. If the central bank suspected that over-expansion or speculation, or gold exports of alarming proportions, were at the bottom of the increased inroads into its reserves, it would counter with an increase in its rate.

In the United States our old state banking systems did not provide for any central organization to protect the banks' gold obligations, nor did they furnish the machinery by which, in case of need, banks could convert their commercial assets into cash or credit balances. The National Bank Act, therefore, required every national bank to maintain against its deposits a certain percentage of actual lawful money reserve, which it was considered should constitute its contribution to the general gold protection of the nation; in addition, credit bank balances in reserve and central reserve cities were to provide a certain liquidity in case of emergencies. The vicious shortcomings of this old method are well known to everybody here, and need not be elaborated.

The Federal Reserve Act brought about a most radical change. It created a system of twelve central banks which, coöperating with one another, were from then on to exercise two important functions in relation to their member banks: first, to provide a sufficient gold cover for the country's gold obligations and, second, to provide the machinery for turning, whenever desired, the member banks' commercial assets into available credit balances or cash.

The first function relieved the member banks of the necessity of keeping in their vaults large amounts of gold for the general protection of the country; the second rendered unnecessary the so-called reserve balances with correspondents in reserve and central reserve cities. The safe and effectual transfer of these burdens to the Federal reserve banks must be predicated, however, upon a sufficient mobilization and concentration of gold in the hands of the Federal reserve banks, and, furthermore, upon the existence of a large volume of standardized commercial and banking paper, easily rediscountable without red tape with the Federal reserve banks. This is where the Federal Reserve Act stopped half-way. It did not say to the member banks, "Maintain with the Federal reserve bank a minimum balance sufficient for the general safety of the country and whatever cash you keep in excess of that in your own vaults—be that gold or silver or Federal reserve notes—is your own concern. But bear in mind that the larger the gold fund produced by the combined contributions from your own vaults, the stronger will be the protection to you and to the entire country." The law continued, instead, the anomaly of requiring member banks to lock up in their vaults hundreds of millions of dollars, thus preventing them by legal enactment from giving additional strength to their own protective system, even if they should want to do so. It further created the anomalous situation that, while a balance with a Federal reserve bank could be considered as reserve, the Federal reserve note could not be so counted, despite the fact that it is a prior lien on the assets of the bank and is the obligation of the United States, while the balance is not.

This inconsistency—to a certain extent at least—has been cured, Congress having passed, upon the recommendation of the Board, a most important amendment authorizing the

Board to permit member banks to keep any portion of their required vault reserve as balances with their Federal reserve banks. In passing this amendment Congress has opened the path for great strides in advance, and it remains to be seen now how far the bankers of the United States will be able to seize this opportunity of doubling the strength of their Federal reserve banks.

There has been a great deal of grumbling, particularly on the part of the country banks, to the effect that their reserve requirements are too heavy, and they have sometimes suggested that they be permitted to continue to count as reserve certain balances kept with their correspondent banks. If member banks' reserve requirements should be found unnecessarily heavy, let us reduce them outright; but do not let us continue the confusion of counting as reserve what—by plain reasoning—should not be called or treated as a reserve. Let us, in our plans for the future, try to look at the problem as a simple question of keeping a sufficient balance with the Federal reserve bank, and when that is maintained leave it to the member bank to keep liquid and strong in its own way. Do not let us apply the term reserve to a balance with another member bank, which may be invested in securities or loaned on the stock exchange; nor let us count as reserve checks in process of collection, and yet, at the same time, treat Federal reserve notes as an asset that cannot be counted as a banking reserve.

In dealing with the problem of adequate reserves, we must first and always consider the question of whether or not our Federal reserve banks are sufficiently strong for the protection of the country or whether they are stronger than necessary. Whenever the latter question can be answered in the affirmative, then only will we be justified in considering the advisability of reducing the member banks' reserve requirements.

What is the Federal Reserve System's lending power to-day? If we set aside a gold reserve of only forty per cent—which may do in times of stress, but is not a proper and sufficient basis in normal times—we find that we have a free gold reserve of about $206,000,000,[1] or if we include the gold now held in cold storage by the Federal reserve agents, about $380,000,000. This means that by additional rediscount operations, or purchases in the open market, for home requirements or for export, we are able to stand a loss of gold of from two to three hundred million dollars. Two hundred million dollars is a very large amount, but when we realize that the nation's gold holdings in one year have increased by about $500,000,000, it is well for us to consider whether or not we shall be able to hold this gold at the end of the War. It is impossible to predict what will then be our economic and financial situation. Perhaps we may find ourselves in an overexpanded or generally unsatisfactory condition, and we may have to face a readjustment in which all our banking strength may be required. On the other hand, things may go well with us, but in the rest of the world there may be a great deal of financial distress. In that case (and it may be the more likely of the two) we shall have almost boundless opportunities, but serious obligations as well. Foreign loans in the Old and the New World may draw away our capital at interest rates far in excess of our own. Our exporters will have to meet the keen competition of other nations, and even though at first there probably will be a strong demand for

[1] Present lending power of the Federal reserve banks (September 1, 1916):

Net deposits (govt. and bank deposits, less float)	$500,008,000	
35 per cent thereof		$175,003,000
Note liability	20,890,000	
40 per cent thereof		8,356,000
Total required reserve against deposit and note liabilities		$183,359,000
Total cash reserve	$365,376,000	
Cash equivalent of F. R. notes on hand	24,084,000	
		$389,460,000
Additional lending power of F. R. banks if loans are taken in lawful money		$206,101,000
Additional lending power if loans are taken in F. R. notes		$515,252,500

certain of our raw materials, the purchasing power of many a country will be found materially reduced. These are conditions which, in the long run, may be the cause of heavy gold exports from the United States and which, if we remain unprepared, may seriously check our progress. If, on the other hand, we forearm, we may grasp the opportunity of taking our place as the strongest of the world's bankers and furnish our industries with the basis for solid expansion.

Does it not appear ridiculous that a country owning over two billions and a half of gold should not be able to mobilize a larger free gold reserve than two or three hundred millions of dollars, particularly when it is apparent that its future financial and economic growth will depend upon the extent of the "preparedness" that it can provide in this respect?

During the critical period following the outbreak of the War in 1914 there were issued $386,000,000 of currency under the so-called Aldrich-Vreeland Act. Has it occurred to you that if a similar amount were needed under the Federal Reserve Act it would absorb a gold reserve, on a forty per cent basis, of $154,000,000? But financial history has shown that each crisis develops larger demands than its predecessor, and with our constantly growing pyramid of deposits and loans, and with the gigantic scale upon which financial transactions are now conducted, it is our duty to be prepared for ever larger demands. The fact that we are strongly forearmed, far beyond a limit expected to be actually reached, will be the only means of restraining these demands to safe and reasonable bounds. We ought to be able, therefore, to lose $300,000,000 to $500,000,000 and still have $200,000,000 or $300,000,000 of free gold to serve as a basis for emergency operations.

I cannot urge you too strongly, therefore, to coöperate to the utmost of your abilities in keeping your balances with the Federal reserve banks high and your vault money down to the minimum that your own till requirements will safely and conveniently permit. It is obvious that in strengthening the Federal reserve banks you are strengthening yourselves.

If a country bank with $25,000 in capital and $150,000 in deposits keeps in its vaults $5,000 or $10,000 of gold, does it expect that, in case of a national emergency, it could protect itself with that amount of legal tender in the event the Federal reserve banks stopped paying in gold or stopped rediscounting? If a country bank's depositors want cash they will be perfectly satisfied to take Federal reserve notes. But the power to furnish these notes, or credit, is limited by the amount of gold held by the Federal reserve banks. While the $5,000 gold in vault of the member bank will not, therefore, protect it, the specie and legal tender notes held by all of them collectively (about $770,000,000) can be made to form the strongest possible bulwark of protection for all if deposited in the Federal reserve banks.

But you may ask me how is it that in Europe central banks control these vast amounts of gold while the deposit balances maintained by the stock banks are comparatively small, and why then should it be necessary for the American member banks to keep such large deposit balances? This is again because we have stopped half-way. The Bank of England issues notes only against gold. The other leading central banks of Europe issue notes against gold (in certain countries gold and silver) and commercial paper. There may be one hundred per cent of gold, but there may not be less than a prescribed minimum gold reserve. But they do not provide that notes may *not* be issued against gold without a certain reserve of commercial paper. That theory—which makes all Europe laugh at us—is, however, the one underlying the Federal Reserve Act. The Board urged Congress to remedy the law in this respect. The Senate responded favorably by passing a bill on these lines, but, unfortunately, it was lost in conference.

It is hard to comprehend why, if this principle has been universally and successfully adopted by the leading central banks and has been the root of their surprising strength during the last two years of terrific strain, it should be arbitrarily condemned or disregarded by us. Let us examine the statements of some of these central banks as they appeared before the War:

METALLIC RESERVES OF THE PRINCIPAL CENTRAL BANKS OF EUROPE[1] AT THE END OF THE CALENDAR YEAR 1913 AND THE PERCENTAGES OF THEIR DEMAND LIABILITIES WHICH WERE REPRESENTED BY NOTES IN CIRCULATION AND DEPOSITS

	Metallic Reserves	*Demand Liabilities*							
	Millions of Dollars	Notes in Circulation		Public Deposits		Private Deposits		Total Deposits	
		Mill. doll.	Per cent	Mill. doll.	Per cent	Mill. doll.	Per cent	Mill. doll.	Per cent
Bank of France	800	1,165	85	63	5	142	10	205	15
Reichsbank	344	617	77	..	..	..	..	189	23
Russian State Bank	818	857	57	490	33	142	10	632	43
Austro-Hungarian Bank	305	506	93	..	..	..	..	38	7
Bank of Italy	233	417	75	40	7	98	18	138	25
Bank of Netherlands	64	134	99	..	..	2	1	2	1
National Bank of Belgium	59	203	91	3	1	17	8	20	9
Swiss National Bank	37	61	84	..	..	..	..	11	16
Federal reserve banks, Sept. 1, 1916	365	14	3	51	9	485	88	536	97

[1] I have not included the Bank of England, because its organization does not provide for so-called elastic note issue, and because during the recent critical period it proved anew its inferiority in this respect as compared with modern central banks like the Banque de France and the Reichsbank. Owing to the rigidity of the structure of the Bank of England, that country could not promptly meet the first pressure following the beginning of the War. There was an inelastic and insufficient note-issuing power and the consequence was that a situation developed in which the government credit had to be thrown into the scales much further than with any other nation. The British government had to guarantee acceptances, discounts, and stock-exchange loans to an almost unlimited extent; it had to issue, in August, 1914, £37,603,000 of small notes to provide the needed currency. I believe it is safe to say that the moratorium and the great inconveniences and losses inflicted upon England's debtor nations might have been avoided if the organization of the Bank

It is evident from these statistics that the United States is following a course diametrically opposed to that of all other central banks. While our central gold reserve, disregarding capital, originates ninety-seven per cent from deposits and three per cent from note issue, the statement of the Bank of the Netherlands shows that it obtains ninety-nine per cent of its metal from circulation and one per cent from deposits. This is the most extreme case, but the table speaks for itself in showing that, with the exception of Russia, where public deposits (for reasons which it would lead too far to explain here) are extraordinarily large, the important European central banks secure their gold reserve from circulation to an extent varying between seventy-five and ninety-nine per cent.

It may be worth our while to analyze further what would be the effect of permitting Federal reserve banks to issue notes in exchange for gold in the manner recommended to Congress by the Federal Reserve Board.

If we added $500,000,000 to the Federal reserve banks' gold holdings by withdrawing gold certificates from circulation and issued against this gold $500,000,000 of Federal reserve notes, the exchange in itself would not alter the volume of the country's total circulation. But our power of protection would be increased. If after such exchange member banks rediscounted with Federal reserve banks $300,000,000 of paper and shipped $300,000,000 of gold to Europe out of the credit balances thus secured, the Federal reserve banks' balance sheet would show against these transactions:

of England had been more modern and possessed of greater elasticity. England's unparalleled power as the world's creditor nation, which was brought into play with marvelous boldness and ingenuity, saved the day for Great Britain and overcame the Bank of England's organic weakness, which with any other nation might have proved fatal.

		Notes Outstanding
Gold, $200,000,000		$500,000,000
300,000,000	Rediscounts against gold shipped	
$500,000,000		$500,000,000

So that the mere exchange would have enabled us to bear a loss of $300,000,000 of gold which otherwise might have affected seriously our financial situation. This argument is based upon the theory that possibly $700,000,000 to $750,000,000 of gold certificates and gold, in addition to other kinds of currency, are at present carried in the pockets of the people and in business tills where Federal reserve notes would serve equally well. The obligations of the United States, secured by all the assets of the Federal reserve banks and a large cover of gold, would remain a trusted medium of exchange unless indeed the credit of the United States went to pieces. Experience has shown that a large and constant volume of notes remains outstanding at all times and that, during a crisis, the amount increases rather than decreases. It is certain, therefore, that a very large sum of gold could be permanently withdrawn from circulation and that, as in Europe, the bank-note circulation would take its place. Against this well recognized practice the hue and cry of inflation has been raised. It is hard to see why a process that spells "elasticity" in France, Germany, Holland, Belgium, Austria, Italy, Sweden, Norway, Russia, Switzerland, and other countries, should spell "inflation" with us. Elasticity without restraint may lead to inflation. But elasticity well regulated by rigid supervision and definite requirements of gold cover, elasticity subject to widest publicity and constant ruthless scrutiny may be trusted not to go very far astray.

As I said the other day, if you need police protection you must not deny the policeman the right to carry a modern revolver for fear that he might shoot the wrong man. If the Federal reserve banks and the Board wanted to run amuck, their present powers are sufficiently large to enable them to do harm. Their ability to do mischief would hardly be increased by the added power, but their ability to protect would grow immeasurably.

Since the Federal reserve banks opened there has come into the United States from abroad over $600,000,000 gold. This stream of gold should have benefited the Federal reserve banks. They should have impounded the gold and issued their Federal reserve notes against it. As it is, they have lost this unique opportunity of gaining additional strength; they have had to stand by idly and let the gold flow into the member banks or go into circulation. Let us throw the searchlight on this bogey, that procuring additional gold by note issue is dangerous, while to obtain it by additional member bank deposits is safe. This will best be accomplished by taking our present combined statement and adding $500,000,000 gold obtained by additional deposits, or as an alternative, adding $500,000,000 obtained by issuing notes in exchange for a like amount of gold, and then comparing the results.

ALTERNATIVE "A"

Assets	Millions of Dollars	*Liabilities*	Millions of Dollars
		Capital	55
		Government deposits	51
Cash reserve, 365 + 500	865	Bank deposits, 485 + 500	985
Earning assets	182	Note liability	14
All other assets	60	Other liability	2
	1,107		1,107
Reserve, 35 per cent on 1,036	363		
40 per cent on 14	6		
	369		
Cash	865		
Free gold	496	purchasing power	
	1,240	note-issuing power	

ALTERNATIVE "B"

Liabilities: In case law permitted issue of Federal reserve notes against gold or paper, or both, as proposed by Federal Reserve Board.

Assets	Millions of Dollars	*Liabilities*	Millions of Dollars
		Capital	55
		Government deposits	51
Cash reserve, 365 + 500	865	Bank deposits	485
Earning assets	182	Note liability, 14 + 500	514
All other assets	60	Other liability	2
	1,107		1,107
Reserve, 35 per cent on 536	188		
40 per cent on 514	206	purchasing power	
		note-issuing power	
	394		
Cash	865		
Free gold	471		
	1,178		

It follows from this illustration that the increase in power "to inflate" is smaller if the added power is obtained by note issue than by deposits. Unwillingness to grant an increase of power cannot be accepted, therefore, as the motive of a Congress which encouraged increase of power by authorizing larger member bank balances. There must be, therefore, another reason. Our critics say: "The theory of the Federal Reserve Act was to issue Federal reserve notes which were to be redeemed at once when the underlying commercial transaction had been completed, and that, by making Federal reserve notes reserve money, or by issuing them in exchange for gold, the note would not be presented promptly for redemption." But have these critics considered that an individual note is never elastic, that it is only the aggregate of notes outstanding, the volume of the entire circulation, which fluctuates and is being made elastic? The degree of this elasticity is controlled by the aggregate of investments made by the Federal reserve banks. Whenever the Federal reserve banks collect their investments at maturity and do not reinvest, they are paid in their own notes, or in lawful money. The result in both cases is the redemption of their notes. In the latter case the Federal reserve notes remain in circulation, but the lawful money takes the place of the maturing paper as cover for the Federal reserve notes and reduces the volume of outstanding circulation to its level before the Federal reserve bank made its investment. As long as the Federal reserve notes remain outstanding an equivalent of lawful money is withdrawn from circulation.[1]

Let us take an extreme case to make our point clear: If we suppose that we had issued two billion dollars of Federal reserve notes against gold and then, in addition, issued two hundred million dollars of Federal reserve notes against commercial paper, there would be two billion, two hundred million dollars of Federal reserve notes outstanding, against which there would be about ninety per cent of gold cover and ten per cent of paper. If the makers of the two hundred millions

[1] Some of our critics strenuously object to the comparatively small accumulation of gold in the hands of the Federal reserve agents as brought about under present circuitous and very cumbersome methods of partially accomplishing the results sought by the proposed amendment. It appears difficult to make these writers see that an exchange par for par of a $10 Federal reserve note for a $10 gold certificate is not an increase of circulation, but a substitution of one note for the other. As long as the gold remains with the Federal reserve agent, the Federal reserve note is, in effect, a gold certificate; with this difference only, that its holder has agreed in advance, in case the Federal reserve banks should be called upon to rediscount heavily, to change his gold-secured Federal reserve note into one secured by commercial paper with a gold reserve of not less than forty per cent. Instead of remaining limited by the free gold secured from member bank balances, the Federal reserve banks are trying to build up a further gold reserve from noteholders willing to trust Uncle Sam, whether he gives them his promise to pay in the form of a gold certificate, silver certificate, greenback, or Federal reserve note. It is needless to add that, in thus strengthening themselves the Federal reserve banks are acting well within the powers given them by the Act.

of commercial paper paid it at maturity with the two hundred millions of Federal reserve notes the *status quo ante* would clearly be reëstablished. But it would be just as clearly reestablished if the makers of the two hundred millions of commercial paper paid it in gold. Then we should have two billion, two hundred million dollars of Federal reserve notes outstanding, against which the bank would hold two billion, two hundred millions of gold. It would simply mean that two hundred millions of gold formerly in circulation, and possibly much worn by use, had been replaced by an equal amount of new and clean Federal reserve notes. In other words, the two hundred millions are redeemed in both cases, no matter whether the specific Federal reserve note is resting in a vault in Oshkosh or is being carried around in the pocket of a farmer in Texas. Whenever the Federal reserve banks collect their paper their notes are in effect redeemed—no matter where or how they are being held. But, under the proposed amendment, instead of having a circulation of which, let us say, ninety per cent is entirely secured by gold and ten per cent is secured by commercial paper with a forty per cent gold reserve, we would have all such outstanding notes secured by about ninety per cent of gold and ten per cent of paper; and if the method I am describing prevailed, the Federal reserve banks could keep their normal reserves much higher than under the present system. If this method were adopted, I, for one, should be in favor of beginning to tax Federal reserve notes at a higher point than at present—let us say whenever the reserve went below sixty per cent instead of forty per cent. This would probably satisfy the fearful minds which apprehend that the increased power might be abused, but it would not prevent the country from securing the greater protective power to which it is entitled.

It will be said that the gold that actually circulated in France and Germany at the beginning of the War proved a most valuable second line of emergency reserve. That is true, and a similar reserve would undoubtedly remain with us, because even if the full program here outlined were realized, we should succeed in concentrating a certain portion only of all our gold. But it has been estimated that the central banks of France and Germany controlled before 1914 about two to three times as much gold as was drawn into their vaults from circulation during the War, while we have only one-fifth of our gold under control and four times that much, that is, two billions, scattered in circulation and in the stock banks. Moreover, there never was before in the world a period of inflation such as is now in process in Europe, and the adjustment after the War will create the keenest competition for the yellow metal.

Our critics say that, by concentrating the gold in the Federal reserve banks, we shall make them the target for gold withdrawals. But they will be that target anyhow. The only question is, will they be able to resist without being forced to take premature and unnecessarily drastic measures of defense? Let us suppose that our member banks' excess cash reserves have been wiped out, either by gold exports or by expansion of the loan and deposit structure; let us suppose that our discount and investment rates are fairly low as compared with those prevailing in Europe; let us suppose that our shipments to foreign countries will no longer exceed our imports. Then, as money flows where it can safely earn the highest returns, our bankers will probably have to finance foreign countries both in government loans and individual transactions. Suppose, then, that Mr. Ivanoff, in Petrograd, draws $100,000 at ninety days' sight on an American banker against a credit granted to him, rediscounts that paper in New York, and, against this balance, Russia wants gold. Where will it come from? The member banks have no more excess reserves; shall we *then* begin to withdraw it from circulation and how and against what? The New York member bank will rediscount $100,000 of bankers' acceptances or commercial paper with its Federal reserve bank and ask for gold. Ultimately, therefore, the demand for gold will be made upon the Federal reserve banks. We are faced with the simple question: Will we be strong enough to share our plenty, during the coming period of stress, with other nations and be the world's banker, or will we be so weak that, when these demands come, we must stop them at once by raising our discount rates high enough to retain our gold at home? Keep all the gold in your vaults, gentlemen, where it is useless for yourselves and deprived of the additional power that it may gain in the hands of the Federal reserve banks; keep every cash-till in hotels, railroad stations, dry goods stores, and what not, filled with gold certificates, and you will rob the country of its legitimate opportunity of growth, of helping itself, and of helping the world. Our foreign competitors will proclaim that only a country willing to part freely with its gold may safely be accepted as a world's banker, and they will point to the fact that, in past critical periods, our banks stopped paying in gold. It is our duty to give to the world an overwhelming evidence of our ability and determination in the future to maintain our gold obligations under any and all circumstances.

The vast accumulation of gold in the hands of the Federal reserve banks which I am urging is of great moment in its bearing upon the future of the national bank currency. The objects contemplated in this respect by the Federal Reserve Act are highly to be commended; but carrying this scheme into effect is subject to too many delays. More comprehensive action from the beginning would have brought about better results. The ultimate aim which we must have in mind is the conversion of a large portion of the two per cent government bonds now securing circulation into new three per cent bonds, a substantial portion of which will gradually be absorbed by the people. This would have the consequence of reducing the amount of national bank circulation, so that, at a given point, whatever two per cent bonds the Federal reserve banks acquired would ultimately be carried by Federal reserve note circulation, and this, in turn, would be of material assistance to the Federal reserve banks in earning their dividends. As the absorption of the three per cent bonds by the public proceeded, and as the growing acceptance market offered a wider field of investment for the Federal reserve banks, Federal reserve notes would take the place of Federal reserve bank notes, bankers' acceptances and commercial paper would take the place of government bonds, and an elastic and live currency would replace the present inelastic government-bond secured currency.

In order to carry out this process, however, it will be necessary normally to maintain against Federal reserve notes at least the forty per cent reserve required by law, as against the five per cent of reserve now required against national bank notes. And this, again, is an added reason for facilitating the concentration of gold in the Federal reserve banks, so that they may be strong enough to sustain this large volume of circulation on the higher reserve basis.

The larger powers which we should enjoy would not, therefore, be employed to inflate circulation. On the contrary, as a net result, it would be used for the purpose of building up a circulation covered by a far stronger gold reserve than that of the national bank notes.

Until the volume of the latter has been materially reduced, and until Federal reserve notes may be accepted as reserve money by the member banks, the lending power of the Federal reserve banks will remain hampered.

In spite of all that has been said by superficial critics about inflation caused by the issue of Federal reserve notes, the Federal reserve banks combined, as a net result, have added to the circulation of the country no more than $14,000,000 of Federal reserve notes.[1] All the rest has in effect been

[1] If we bear in mind that on September 1st, 1916, the Federal reserve banks had on hand a total of about $24,000,000 Federal reserve notes, we must

redeemed by depositing gold. Of Federal reserve bank notes, as a net result, there have been placed in circulation less than $2,000,000, while $55,000,000 government bonds have been purchased from member banks and national bank circulation has been reduced by about $50,000,000. We certainly have not inflated there!

It has been said by some critics that Federal reserve banks should not, under any circumstances, issue Federal reserve *bank* notes. There is no doubt that the national bank note circulation is an objectionable feature in our monetary system, but the fact remains that the country is accustomed and adjusted to a certain volume of currency, and we could not eliminate about $700,000,000 of it without putting something in its stead. It is most important that the process of filling demands for currency by issuing national bank notes should stop, and that, by a gradual reduction of the outstanding volume a vacuum be created for Federal reserve note circulation. But pending this process of gradual substitution—that is, the process of purchasing government bonds from member banks, conversion into three per cent bonds and one-year notes, sale to the public of three per cent bonds, and reinvestment of the proceeds in commercial or banking paper—there will be an interregnum when Federal reserve *bank* notes must be issued temporarily, until there is available a sufficient amount of paper to take the place of government bonds, a sufficient absorption of these bonds by the public, and a sufficient strength in gold reserves.

Let us bear in mind that Federal reserve *bank* circulation is not added circulation, but a partial substitution of new notes for redeemed old national bank circulation, and that, when issued by Federal reserve banks, it will have a certain degree of elasticity, because it will be issued from time to

admit that, as a net result of their issue activities, the volume of the country's circulation has not expanded, but has been actually contracted to the extent of over $6,000,000.

time only in harmony with the general policy of the Federal reserve banks and not kept out perpetually for the sake of the profit involved, as now done by the national banks.

The Federal reserve banks have made investments aggregating at present about $180,000,000 and have outstanding a net circulation of about $16,000,000. That means that for $164,000,000 of investments they have paid gold and thereby have reduced their reserve power to that extent.

If they could have paid in Federal reserve notes instead of gold, as they should have been permitted to do, they would have lost only forty per cent of this amount and would have retained the balance, that is, about 100 millions, as a potential reserve for additional note issue. As stated before, it does not necessarily follow that Federal reserve banks would have made larger investments at this time; it is not at all likely that they would have done so. But emphasis must be laid upon the resulting reduction of their power to assist the country in an emergency.

The argument is used that if Federal reserve notes had been paid out and could have been counted as reserve money by the stock banks, these notes would have gone into the vaults of the member banks as reserve money and caused a further expansion of loans. But we must not forget that the same result followed the payment by the Federal reserve banks of gold. As far as the member banks are concerned, the effect is the same whether they receive $164,000,000 in gold or in Federal reserve notes which may be counted as gold. But the difference is, as we stated, that under the present system the lending power of the Federal Reserve System is being impaired too fast.

Federal reserve notes "shall be obligations of the United States and shall be receivable by all national and member banks and the Federal reserve banks and for all taxes, customs, and public dues. They shall be redeemed in gold at the Treasury," etc.

Did we not stop half-way when we provided that banks are thus to receive Federal reserve notes in payment of debts to each other, and from their depositors, but cannot count them as reserve for the purpose of discharging their deposit liabilities? As a consequence, banks, when settling with each other through clearing, do not accept Federal reserve notes, but must settle in lawful reserve money—that is, substantially in gold. If, however, a bank settled directly with another bank it could pay in Federal reserve notes and the payee bank could then send the Federal reserve notes to its Federal reserve bank, create a balance and then count that as reserve.

It is fortunate that the new amendment will permit member banks to carry any part of their required vault reserve as a balance with the Federal reserve bank and to count it as reserve. It is hoped that this will cause member banks promptly to adopt the habit of settling their balances with each other by transfer of credit through their Federal reserve banks, thereby releasing gold needlessly tied up in clearing operations and in their vaults, and remedying, to a certain extent at least, these anomalous conditions.

In dealing with this question of reserves and note issue, it is proper and necessary that we proceed step by step. Splendid progress has been made in these last two years and we realize, of course, that the tracks must be shifted many a time before we can reach our final goal. But we must be clear about this ultimate aim and we must recognize the absolute necessity of taking certain consecutive steps before monetary and banking reform will be complete.

Ultimately we must rid our country of the confusing multiplicity of currency with which we are now afflicted, and the Treasury will have to stop issuing small-denomination gold certificates. The circulating currency of the country ought to be silver certificates in the small denominations, and Federal reserve notes. The best place for gold and gold certificates will be in the Federal reserve banks. The national bank currency ought to be systematically withdrawn, and the greenbacks ought to be gradually turned into gold certificates as the missing gold cover from time to time is created by the excess profits to be received from the Federal reserve banks or by some more rapid process that the future may evolve. While this process is taking its course I think we are fully justified in permitting the Federal reserve banks to count greenbacks as part of their metallic reserve. It is freely admitted that this is not absolutely good banking theory. But with the $153,000,000 gold behind these notes and the power given to the United States to provide the additional gold cover by sale of government bonds, we may be warranted in temporizing and not making an over-rigid discrimination.

One cannot deal with the future of our Federal Reserve System and our reserve problem without being puzzled by the question, what will be the coming standard of differentiation between central reserve cities, reserve cities, and country bank places when, after November 16th, 1917, balances with correspondent banks will no longer count as reserve. I cannot undertake to discuss that problem to-day, but I think it is timely to point to this phase and invite you to give it your most careful consideration. The time is not distant when we shall have to deal with this conundrum and we shall welcome —indeed, we shall need—your very best thoughts in the matter.

The Federal Reserve System is the beginning of an imposing structure to be erected upon a broad foundation. It will prove a costly edifice unless it is developed to its full growth along these broad lines. Member banks and the country at large have a very vital and obvious interest in this, and they may well insist that there be no stopping half-way or haphazard additions or little patchwork here and there.

The banks and the country are now entitled to enjoy, and will soon require, the strongest possible system, and the further it progresses, the more the concentration of gold in the Federal reserve banks proceeds, the further the discount market develops, and the further grows the habit of banks, large and small, to invest in bankers' and trade acceptances, the less will it be necessary for them to keep unduly large sums locked up in their vaults and the easier will it be for Federal reserve banks to return a portion of their paid-in capital. The roads to reduced reserve and capital requirements lie in these directions.

If member banks are to rely for their protection primarily upon their ability to create balances with their Federal reserve banks they must be certain that they have in their possession an easy means of approach, a reliable key that will open for them the door leading to the Federal reserve banks' vaults.

The amendments just passed by Congress are of great importance in this respect. Domestic acceptances will prove not only an efficient means of directing idle funds to districts where they may be profitably employed, thus working towards greater equalization of interest rates—but the increased supply of eligible banking paper will render much more easily accessible the credit facilities of the Federal reserve banks.

I do not think that I should dwell here on what I said to the New York state banking institutions at Atlantic City a few months ago. Let me only state again that I consider it the duty and at the same time the best self-interest of strong state banks and trust companies to join the System and contribute their share to the gold reserve fund that is being accumulated for the protection and progress of the United States. We have liberalized to the utmost of our ability the conditions under which these institutions may enter and be members of the System. They may join with all their banking powers practically undiminished. It has been the aim of the Board to bring about a basis of parity between state banks and national banks—not by needlessly tying the hands of the state institutions, but rather by unshackling the hands of the national banks where they are needlessly tied.

The amendments recommended by the Board, most of which have now become law, such as power through ownership of certain bank stocks to operate in foreign countries, to accept drafts for domestic transactions, and for certain classes of finance drafts for the promotion of our foreign banking, to make loans on mortgages, etc., are evidence of the Board's policy in this respect. In the same spirit the Board hopes that national banks will be granted the power to operate branches in cities where state laws do not prohibit state banking institutions from operating similar branches. Some banks have raised a cry of alarm and have severely arraigned us for appearing to foster a branch banking monopoly apt to crowd out the small bank. But where state banks and trust companies enjoy the right to operate branches (in New York City alone there are over 100 branches of such institutions) small banks are already subject to the competition of these state bank and trust company branches. National bank branches would, therefore, hardly add to the alleged discomfort of the small banks, while it appears unfair to deny this right to national banks where their competitors, the state institutions, freely exercise it.

I do not believe that we should adopt the Canadian or European branch banking system. It contains elements of excessive centralization which, with the American spirit of aggressive fight for supremacy and control, would lead to unsound and undesirable conditions. But, restricted to city lines —where state laws permit—branch banking would not justify an outburst of hysterical fear of the octopus. It would rather give an opportunity to the smaller and weaker banks to combine. It would thus enable them more effectively to meet the competition of their more powerful neighbors, to make better profits and to give better facilities to the customers they serve.

Self-respect and public opinion will not permit the state institutions long to remain in the position of shirking their duty towards the nation, and the state banks, at the expense of the national banks, and to the detriment of the entire country, cannot afford to refuse to bear their fair share of the burden, nor can they afford to be deprived of their fair share of the advantages.

I do not deny that, for some state institutions, particularly those that have private bankers on their boards, it may prove a hardship to lose some valuable directors, and that free balances with Federal reserve banks mean some loss of interest for most of these potential state member banks. But if that is the price to be paid for a system which is to insure the banks and the industries of the country against the horrors of some of the panics of the past and which will give us the possibility of future growth in relative safety under a modern system of mutual protection—then these sacrifices ought to be borne cheerfully by everybody as, indeed, being none too onerous.

While thus I do not hesitate to confess freely that there are certain necessary inconveniences that have to be borne for the general good, I hold with equal emphasis that it is our duty to remove the unnecessary shackles that hamper and inconvenience the banks of our country more than those of any other nation in the world. My vision of the future would be very unsatisfactory, indeed, if it did not permit me to hope for the reversing of many an antiquated ruling, court decision, or law, which needs overhauling. Indeed, I see herein one of the most fruitful fields for the study and activity of the Federal Reserve Board.

It would lead too far at this time to do more than barely epitomize these thoughts. If banking in Europe is being carried on largely by cash advances on deposit account, why should it be unlawful with us to grant such overdrafts to business concerns? Do you realize that all rulings in this respect have been based mainly upon a court decision rendered in 1828, involving a construction of the powers of a bank operated under a charter granted by Congress in 1812, about fifty years prior to the passage of the National Bank Act?

Let me ask you further: Why should it be unlawful to charge interest in excess of six per cent? The present discount rate of the Bank of England is six per cent and large corporations and firms in that country no doubt pay more than six per cent for their present credit facilities without the stigma of usury attaching to the British banks charging the higher rates. When money generally is worth three per cent, a charge of five per cent may be excessive; but when money is generally worth six per cent, a charge of seven per cent should not be considered usury. I strongly believe in the protection of the public against extortionate rates, and to stabilize rates as far as practicable on a moderate basis is one of the chief aims and objects of the Federal Reserve Act. But we should have reasonable laws, laws recognizing the fluctuating value of money, like that of any other commodity, and recognizing that usury exists only where there is a question of extortion—where the borrower finds himself in a helpless condition. But where strong and solvent concerns, of their own free will, contract for loans, there can be no question of usury. We should modernize our laws in this respect.

Why should national banks be prevented from taking commissions? In Europe the commission account of banks is the one to which they point with the greatest pride. Any bank may execute orders for the investment of funds. I cannot see why the investment of depositors' funds should not be a proper function of banks.

We have discussed the structure of the Federal Reserve System—the foundation and the building we expect to see erected upon it. Now the final question—who shall be the master of the house? Shall it be business or politics or a neutral, non-business and non-partisan, judicial administration? I have no doubt that the country wants the latter, and I am delighted to say that the character of the Reserve

Board and of the administration of the reserve banks is of that nature to-day. But if we want to be certain of the future, I believe that nothing should be left undone that will insure the greatest independence of the Board and will thus make the positions of members of the Board such that, in coming generations, these offices will be coveted by men of worth, like seats on the Supreme Bench of the United States. The safety of the country and the confidence that the Federal Reserve System will enjoy are dependent upon the character and the ability of the men charged with its administration. If a safe future is to be assured to the System, the Act must be perfected where it stopped half-way in this respect. Of course there must be at all times intimate relations between the Treasury and the Federal Reserve Board and coöperation in broad questions of national policy, but there must be only one banking and discount policy and not the possibility of two. The law should provide that the administration of the Treasury funds within the Federal Reserve System should be subject to some control by the Board, and emergency relief operations ought to be carried out through the Federal reserve banks and not directly through deposits with member banks by the Treasury.

The business and banking community should feel certain that the adjustment between Treasury and member banks will take place at all times in a natural, well-regulated manner, in keeping with the general banking policy adopted by the Federal Reserve Board and the Federal reserve banks. If at certain periods large payments are to be made by the member banks to the Treasury, there should be an easy adjustment by having the money withdrawn operate to strengthen the Federal Reserve System, leaving it to the Board and the Federal reserve banks, by rediscounting short paper, to return to the member banks sufficient funds to reëstablish the equilibrium. But this important function of balancing the scales ought to be the constant care of the Board, under a consistent plan of operation, and not the domain of the changing and arbitrary policies and views of each succeeding Secretary of the Treasury. That was the original plan of the Glass Bill; unfortunately it was changed in conference. It is much to be hoped that a return be made very soon in the direction of the original project so that the danger be removed that at some future time Federal reserve banks or member banks may ask and secure Treasury deposits without consultation with, and even in opposition to, the wishes and policy of the Federal Reserve Board.

In a similar way, the Board's authority and efficiency ought to be strengthened by providing that examinations and rulings by the Comptroller's office, and the compilation of banking statistics should be carried on under the auspices of the Board. However the present members may have been able, by personal effort, to meet the organic defects of the law—the fact remains that, as it stands to-day, it places the Board half-way between independence and dependence. It cannot remain long in that position. Evolution will carry it either in one direction or the other. The country will have to decide which development it desires and express itself in no uncertain voice.

I need hardly say that, whatever views I have expressed in this address, I have given you as my own personal convictions without attempting in any way to speak for my colleagues. I want to emphasize, furthermore, that whatever I have just said concerning relations between the Treasury Department, the Comptroller's office, and the Board must be considered as a strictly impersonal statement, having no relation whatever to present incumbents, who are bound by the law as it stands, and applying solely to principles which have an important bearing upon the future.

And now, in closing, let me say again that I am an unqualified believer in and enthusiastic supporter of the Federal Reserve System. Its fundamental principles are sound; its benefits to the country have been immense and will become more apparent with each succeeding year. Though from the point of view of banking technique, one single central bank would have been easier to administer and, in some respects, might have been more economical and efficient, I am convinced that the undisturbed development of our financial system is better assured and that danger of business or political control is more certain to be avoided by a system of coördinated central banks. That the System might possibly be simplified and made stronger and more efficient by merging some of the districts, is an opinion held by many, a view which I entertained before the organization of the districts, and to which I am still wedded.

The Federal Reserve System is an ingenious combination of centralization and decentralization. But decentralization carried too far defeats its own ends. If you try to create 100 independent centers each will be too weak to act as a point of crystallization, and, as a result, they will all depend upon the one that is the strongest amongst them. If it is the object of the System to counteract the preponderance of one district, the other districts must be strong enough to become independent centers of importance, containing a sufficient degree of diversity of interests, and sufficiently imposing to command undoubted prestige and confidence. By merging a few districts into twin districts, greater strength, greater efficiency, and cheaper operation might be secured, without changing or weakening the intimate touch now secured by the respective local organization.

But actual experience will guide us ultimately in adjusting this problem. The principle, as I have said, is sound, and it is the duty of every one of us to devote all our energy and our best thought towards bringing it to its fullest fruition. Let us be frank in our criticism, but at the same time fair. We are never more severe than when we criticize our own children—that is because we love them best and entertain for them the highest ambitions. That is why I have been frank to-day—

because I do care for this System, because I do care for this country and want it to succeed and take its proper place as a financial and industrial power amongst nations. That is why I think that the bankers of the country whose own success or failure is so closely linked to the future development of the Federal Reserve System should now set their minds upon its problems in the same spirit, as friends of the System, as fathers —if you please—who want to see their child grow and develop, even if it entails some sacrifices upon the parents.

The greatest obstacle in the way of the Federal Reserve System's freest and most beneficial development is, on the one hand, selfishness on the part of some of our members, whose vision does not reach beyond their own limited sphere, and who are unable to grasp the larger question of the safety and future of the country, and suspicion, prejudice, and half-knowledge, on the other. These obstacles will be overcome by public opinion based upon better education. In this work of national scope and importance your Association can render the greatest service. It can lead within its membership in developing sound banking practices and good banking ethics; and, as towards the public, it can lead in the work of teaching the gospel of modern and clean banking and help in enacting sound practices into sound law.

At the time of the opening of the Federal reserve banks, Sir George Paish said to me, "The future of your System will depend upon your ability to get under the control of the Federal reserve banks the scattered gold of your country." Two years have passed since. We have made great headway in many respects, but the organized control of our gold is still in its incipient stage. One reason for this disappointing condition is that the state institutions have not done their duty towards the System; the other is that there has not been enough clear thinking and too much immature criticism. Congress will not give us the necessary relief until there is greater accord in the minds of the banks and our financial writers.

Has it occurred to some of our critics that, before assailing us, it should be their duty to stop to consider that there is a difference between reserves of central banks and reserves of member banks, and that a greenback and a Federal reserve note are as different as day and night—the one issued as a perpetual currency to pay 200 millions of the government's debts, and the other issuable only against the purchase of self-liquidating paper, expanding and contracting according to the amounts so invested, and secured by a generous minimum reserve of gold? Let them bear in mind that it was this kind of superficial but persistent criticism which stood in the way of banking reform in years gone by; that made us endure the painful experience of 1907 before submitting to the remedy of more modern methods, and delayed final action until, half prepared, we had to meet the storm of 1914, subject to disturbances and sufferings which we might have avoided, and losing opportunities which should have been ours.

Some of these critics, sitting in their little chairs at their little desks, within their four little walls, with very little knowledge and very big words, stake their own local views against the world's acknowledged experience. They disregard the fact that buildings have grown so high and reached such dimensions that fire engines and water mains—the weapons of protection—must be of the most powerful and most modern type. Some of them appear to think "that the engine that was used when father's house burnt down to the ground is good enough for everybody and that the big new houses won't burn anyhow"; others have a fire engine of their own invention, never tried, but better than all the rest; others are "sore" because they, themselves, are no longer the fire chiefs; and some object because they do not wish to pay their share for adequate protection.

But, gentlemen, let those of us who believe in foresight, experience, and coöperation stand together, and let us secure the very best possible protection, without hysteria and extravagance—not as schemers, but as conservative and conscientious men, as cautious captains alive to our responsibilities and to the storms that must come.

Immediately after the beginning of the War, Hartley Withers wrote, in *The War and Lombard Street:*

> It was the chance of a century for New York. American ambition has long informed the world that the United States, having been the world's granary, is now the world's most progressive manufacturer, and means soon to be the world's banker. This may happen some day, and might have happened already if American policy in currency, financial and fiscal matters had been more thrifty. But they have tied their credit system in the bonds of narrow banking laws and their trade in those of a cramping tariff. These bonds they have just begun to shake off, and if the crisis had happened a few years later they might perhaps have made a bid for London's place as the world banker.
>
> It was the chance of a century, but New York could not take it. When London called in its credits from other countries, any center that could have said to these countries, "We will give you the credit that London has cut off, and lend you the money to pay London," would have stepped straight on to London's financial throne and set London a very difficult task to regain it after the War was over. In spite of the large amounts of gold taken from America to Europe before the War, the United States had still a huge store within its borders—some estimates of it ranged up to 400 million sterling. If the United States had had the courage to use this mountain of metal and let other countries draw on it, London would have had more gold than it knew what to do with, and New York would have had a big slice of London's business. But America feared to use its gold and held on to it as tightly as it could, fearful of internal trouble and a run on its banks, if too much of the metal went abroad.

Since writing the above two years ago, Mr. Withers has greatly modified his views. In his latest book, *International Finance*, published a few months ago, he says:

> America is now one of the leading powers in international finance, and on the wise and skillful use of its strength the future prosperity of the civilized world will, to a great extent, depend.

Shall we be found wanting? The answer will largely depend upon you, the bankers of the United States; upon the strength you give to your Federal Reserve System and upon your contribution to the moulding of its future.

APRIL 7, 1917

XXI

GOVERNMENT AND BUSINESS

Address Before the Commercial Club of Chicago, Ill.

IT is about twenty-four years since I came to the United States for the first time, and, taking things in the sequence of their true importance, I came to see Chicago first and New York afterwards—incidentally coming from Japan. I have since been a frequent visitor to this wonderful city, and every time I have come back I have been impressed anew with its continued growth as one of our most important centers of commerce and as a leader in civic thought. One of my visits here stands out with particular clearness in my memory. That is when I came here in April, 1911, delegated by a convention of chambers of commerce and boards of trade, in order to assist in the formation of a business men's league for the promotion of financial reform, a movement at that time still in its swaddling clothes.

This work was taken up by a group of your leading citizens with the intelligence and energy characteristic of your city, and if our country was able to pass through the last three years without any financial disturbance, strong enough to meet the phenomenal requirements made upon us, and if to-day we find ourselves fully prepared to carry the still greater burdens that the public interest may require us to shoulder, these men may feel that they have done their full share in bringing about this happy result. Without the comprehensive campaign of education preceding the enactment of the Federal Reserve Act so far-reaching a reform could not have been carried out in proper time. I am particularly grateful for being accorded this privilege of addressing the business men of Chicago, because it gives me a welcome opportunity of paying tribute to the part played by your citizens in this epoch-making work of monetary reform.

Those of us who know the Bible remember the chapter on the Tower of Babel. The story of the world's first skyscraper is the parable of the conceit and downfall of mankind. Confident in his ability to overcome any difficulty, man undertook to build a tower that would reach to the skies—and the world fell into general confusion. That is the world's condition to-day.

And those of us who know the old Greek tragedies could not contemplate the spread of the conflagration throughout the Old World without feeling that three hundred million people were drawn into the present world contest by forces stronger than they; a power akin to the Fate that the Greeks held to be superior even to the gods; the cumulative effects and consequences of dynastic and racial feuds of generations and of inevitable economic developments.

The great calamity that has befallen Europe would, indeed, awaken in us nothing but a feeling of utter despair of the ultimate ability of the human race to rise from its aboriginal level, were it not for the confidence that out of this struggle there will come to the world a greater liberty of man and a loftier understanding of human rights; and, furthermore, for the redeeming thought that it is the profound belief in the sacred mission of their respective races that makes gentle and peaceful individuals willing, for the greater glory and advantage of their tribes, to endure and to inflict untold hardships and cruel sufferings.

In the latter respect our own problems and ideals in entering the War differ from those of Europe. The race thought is foreign to our country as a motive for making war. The United States is not a one-race country; all the tribes of the world have brought to these shores that which is most characteristic in their strain, and merged it into the composite type of the citizen of the New World. When the United States goes to war, it can never be a race war; it must be a war for a principle, for liberty, or for human rights. It can never be a war by a race against a race; but a war by people holding to one principle against people holding to another. Our greatest contribution to the world's development is that we are giving the living proof that common aims and ideals can be stronger than racial differences. The die being cast there can be only one duty for any citizen, and that is to stand loyally by the flag of his country. But that duty is doubly strong with us, where any hesitation in that respect would shake the fundamental thought of the Union—which is: that its citizens must abandon the smaller racial or sectional thought and subordinate it to the higher duty of loyalty and allegiance to the principles of liberty, justice, and equality upon which the United States is founded. That does not mean that we should cease to love the people who were near and dear to us in the old countries where the cradle of our ancestors, or even our own, stood, or that we should forget that every one of these old races has given us some great contribution towards the higher development of our own country. During our Civil War many a brave man continued to love his brother, even though he found himself forced to fight him on the field of battle. But this tragic conflict of affections could not shake his loyalty to the cause he had espoused. And so it must and will be with us. When our country goes to war it has a right to expect and demand of all its citizens a willingness to serve and to suffer and to die. No matter what this may entail for any of us, about our whole-hearted and unquestioning allegiance to our flag, about our unhesitating readiness to stand by our President and to do our duty, there can be no possible doubt.

This duty may be performed in many ways—service personally with the colors, organizing the various industries of the country for the benefit of the government, responding promptly to the offerings of public loans, economizing in our everyday life and bearing willingly whatever burdens or taxes the government sees fit to impose.

Under the particular circumstances in which we enter the War the financial aid that our country will be able to render will be one of our most important contributions, and I have no doubt that in whatever way our government will finally decide to appeal to the American investor he will respond with an alacrity and in a spirit that will astound the world.

It is a profound satisfaction to all of us to know that never before was this country financially as strong and as well prepared as it is to-day. During the last three years our gold holdings have increased by 57 per cent from $1,900,000,000 to about $3,000,000,000. In addition, as you are well aware, we have improved our position as against other nations by repurchasing our own securities and making foreign loans to an amount approaching $5,000,000,000.

Moreover, by the establishment of our Federal Reserve System we have organized this enormous strength. We have brought into effective coördination a large portion of the country's banking reserves. We have regulated and brought about a general understanding of modern methods of rediscounting. We have created a new wide market for bankers' acceptances, so that our member banks now have an easy means of recourse to the Federal reserve banks in case they wish to replenish their reserves.

We have established fiscal agency relations between these banks and the government and perfected an instrument which may prove of great value in placing issues of our government securities. Not so much by investing their own funds, except when dealing with short maturities, but by acting as a medium of distribution, the Federal reserve banks may play a most important part in facilitating the participation of all sections of the country, in receiving the payments for subscriptions, and in adjusting any drastic dislocation of funds that might arise through heavy payments by the banks to the Treasury.

We have available a vast supply of notes of undoubted solidity ready to be issued whenever there may be a demand; and, through the inter-district gold clearing fund, we have established machinery for the freest exchange of balances between the various parts of the country.[1] Not by any stretch of imagination could we perceive the possibility of a gold premium between the various American centers or a currency famine as in years gone by. About our power to take care of ourselves there can be no doubt. But in view of the unparalleled demands that may be made upon us both during the War and after the conclusion of peace, demands which it may be our highest national interest and duty to satisfy—we should not neglect to perfect our financial machinery to such a degree as to give it the greatest possible strength.

For this reason the Federal Reserve Board has again recommended to Congress amendments having for their object a still further concentration in the Federal reserve banks of gold now held in scattered bank reserves and a more liberal substitution of Federal reserve notes for our present rigid 100 per cent gold certificate circulation.

One billion dollars, one-third of the gold holdings of the United States, is at present "unaccounted for"; you and I carry it in our pockets, it is in the tills of the baker, the grocer, and the dry goods store. We all would just as lief take Federal reserve notes—our government's absolute obligation secured at present by practically 100 per cent of gold and all the assets of the Federal reserve banks. It is as apparent that it would increase our strength enormously if we could add to our organized reserves a substantial portion of this wasted gold, as it is obvious that it would be nothing short of a crime wilfully to withhold from our country at this time so vital an addition to its power of offense and defense.

[1] Instead of shipping currency from one district to another we have transferred ownership of gold by book entries averaging about one billion dollars a month for the more recent period. Our clearing per day amounts now to about $100,000,000.

Unfortunately, in the general tie-up of all legislative work at the end of the preceding session, Congress was unable to pass the desired legislation. It is most essential for the best interests of the country that prompt action be taken by the present Congress and it is most desirable that public opinion assist the committees on banking and currency in securing early and favorable consideration of these amendments, which will enable us promptly to complete our financial mobilization.

When many months ago I accepted your flattering invitation and selected "Government and Business" as the topic for my address, I did not anticipate that between then and now conditions would take so serious a turn that the relation of government and business in times of peace would hardly be of interest to my audience. But just because at this present juncture we see so plainly how largely a country's fate depends upon its railroads, its shipping, its industries, and its finances, and just because we perceive so clearly how essential it is to secure consistent development and preparation in times of peace, it may be worth while to stop and analyze the gradual growth in importance of the interrelation of government and business. We may well ask ourselves: "Has government activity in business—generally called regulation—come to stay?" "Is its future scope going to increase or decrease?" "Can modern business succeed without it?" "What is the attitude of business toward government and government toward business, and what should it be?" These are large questions which it would be interesting to discuss in the light of the past, present, and future, but we cannot do more than dwell to-night upon the most essential phases of the problem.

Some of the chief economic changes brought about in Europe during the past century have been: The transformation of nations from political entities into political and economic units; the evolution from mainly agrarian into industrial states; from decentralized, self-contained, and self-supporting individual activity to strictly specialized vocation. This development has brought about wholesale production on the part of the individual and community, depending upon broad national and international markets both for the sale of excess products and for the purchase of many articles of necessity and luxury. It has resulted in making every country dependent upon the goods of others.

When Napoleon I overran Europe, a little over one hundred years ago, England was the only industrial or manufacturing country. Germany was then a multitude of small, separate, agrarian states, a country of "poets and thinkers." When Napoleon closed the continent against England he cut off the latter's trade in such articles as cotton and woolen goods, steel, coal, and glass, just as Germany has been deprived to-day of her foreign trade. But he could never have thought that, in so doing, he might be subjecting to famine a large continent which at that time was essentially agrarian and entirely self-supporting with respect to foodstuffs.

Prussia's defeat at the hands of Napoleon brought forth in that country the theory of "a people in arms." Since then, universal service has gradually been adopted by all the leading nations on the European continent, and at the same time most of them have become, to a greater or lesser degree, industrial countries. These two evolutions have been most important factors in the making of modern history.

Industrial development enables a nation to sustain within its boundaries a larger population than it can support by its own agricultural products, provided it can trade with countries that have a surplus of such foodstuffs. Larger population and taxing power mean, in turn, the possibility of creating greater armies. But industrial countries are vulnerable if they can be cut off from other nations which supply them with raw materials essential for their daily life.

Here we have in a nutshell the European problem, as it lay at the root of the present world catastrophe, and we see the importance of the part played by business in this connection. Given the wicked division of Europe into two armed camps, of fairly equal power, it is obvious that each side must have watched with the greatest concern any change in any of these three important items: population, wealth, and ocean control. Wealth is all the more important because the efficiency of modern armies and navies is dependent upon the most modern and ample equipment, a dependence which in turn resolves itself into a question of financial endurance.

Modern warfare has since developed the fact that defeat or victory depends upon the degree of speed and efficiency with which unheard-of quantities of ammunition and instruments of war can be supplied. And a country's ability quickly to organize and mobilize its industries has become a most essential factor in the struggle of the nations.

This explains why European governments, in questions of commerce and production, have long ceased to be simply regulators of business, and have become active promoters of business, and at times have even become partners in it, or have themselves become producers.

Not on account of the welfare of the individuals concerned, but on account of the national importance of these subjects, governments are vitally interested in proper tariffs and commercial treaties. Railroading and shipping are likewise objects of the care of government—not merely because of their strategic importance, but because of the bearing that efficient transportation has upon a country's development and its ability to compete with other nations.

In railroading and shipping we find in the world to-day all kinds of government influence, from state subventions and control of tariffs, to joint partnerships between private capital and government, and complete government ownership and operation.

In a similar manner, we see governments actively promoting agriculture and new industries, we see them organizing their industries into aggressive syndicates (and cartels), and we see a growing tendency on the part of almost all countries to control and develop their own natural resources. At present we see in Europe governments operating factories and regulating almost every phase of demand and supply to a degree never before known. We have seen some governments at work developing new markets by acquiring and operating new colonies.

We have seen in Europe during the last twenty years a growth of control by governments of the national power to save and invest in foreign countries. Foreign loans were directed by governments to points where they were to produce business for the lending nation, or where they were to assist politically allied countries, or where—through financial aid rendered—other countries were to be drawn into closer commercial and political relations. Loans granted to China, Russia, Turkey, and the Balkan States are illustrations of such a policy.

We all fervently hope that the end of the War will bring about conditions enabling all powers to reduce armaments, thus lessening the urgent necessity for governments to secure increased revenues for the sake of maintaining large armies and navies. On the other hand, the debts of the leading powers of Europe have increased at such an unparalleled rate that what seemed an unbearable military burden in the past will appear small as compared with the financial burden of the future.

If we take the average for the three years preceding the War, we find that England, France, and Germany together have been spending annually for their armies and navies about $1,000,000,000. Their combined debt service for 1914 amounted to about $430,000,000. Their annual interest charge, without amortization, on the basis of their present funded indebtedness, amounts to about $2,180,000,000 per annum, or more than twice the amount formerly spent for armies and navies.

The consequence will be that the future business activities of governments, in scope and intensity, will not be decreased, but will be increased. It will have to be their concern to rebuild their country's trade, to bring it back into conformity with the normal requirements of nations at peace, to secure larger revenue from a weakened people, to reduce to a minimum imports for the purpose of unproductive consumption, and to increase to the maximum the exporting power of the nation. Every country in the world has learned during the last three years the necessity of developing its own resources and of becoming less dependent upon other countries for its normal requirements. There will be a tendency, I believe, on the part of most of the leading nations, after the establishment of peace, to keep their trade balances under government control by restricting importations, particularly of luxuries, by regulating home consumption, and by bringing about the lowest possible cost of production on the broadest possible basis of organized coöperation. I have no doubt that government monopolies will be established for the production of many important articles. Exchange of goods between countries, once the shortages of raw materials and finished products have been met, will, to my mind, be decreased in volume, rather than increased, as compared with pre-war times. And wherever purchasing power exists there will be the keenest kind of organized competition to secure the contracts for the goods required.

I have outlined these conditions at such length in order to ask the question: "In the face of the ultra-organization to be expected of other countries, can we afford to believe that when peace is restored we can meet this competition, or hold our own, unless we likewise systematize or organize our individual efforts?"

Furthermore, if in Europe it is necessary to have governments take an active part in organizing industries and banking, may we assume that it can be done without government regulation in a country which by law and sentiment much more than Europe is opposed to extensive combinations in industries and banking?

We are all in accord, I believe, in thinking that, if at all possible, the operation of industries by party governments in the United States should be avoided. Where regulation is required and where regulation borders on the field of operation, it is best exercised through non-partisan government bodies. Leaving aside the councils and commissions organized for the purpose of dealing with emergency situations, we have bodies of that kind in the Interstate Commerce Commission, the Federal Reserve Board, the Federal Trade Commission, the United States Shipping Board, and the Tariff Commission. The task of government regulation is as complex as it is ungrateful. It is largely a judicial function. Those charged with it must hear the producer and the consumer, the shipper and the carrier, the borrower and the lender, and find a course that is fair to all, at the same time taking into consideration the larger question of the interests of the entire country in its national and international aspects. In addition, the problem of the producer and the shipper must be dealt with from the two-fold point of view of capital and of labor.

Foreign governments which own and operate coal mines, and thereby regulate the price of fuel, are interested in securing large revenue resulting from a combination of high prices for coal and low cost of production. At the same time, however, they have to consider the millions of individual consumers, the manufacturer, who must be able to compete in the world market, and finally the miner, who is entitled to reasonable wages. Efficient government regulation must conscientiously weigh all these aspects with fairness towards all, with malice towards none. It cannot please all sides; it probably will invariably displease some party involved in the question, or even all. But the test of its work does not lie in praise or blame. There is only one standard to be applied, and that is: "Has its work been fair, and, first of all, has it been constructive?"

When by reduction of rates and improvement of service excessive dividends on watered railroad stock are cut, no harm is done, provided the country at large profits from such action. If, however, by going to an extreme in this direction the corporation's credit is impaired, and its ability to grow and expand is thereby destroyed, regulation proves a failure. The carrier, by exacting extortionate rates, may hurt its own interests because it is bound to weaken or even destroy the shipper, or drive him away to other lines. Conversely, the shipper, by securing excessively low rates, may destroy the railroad's ability to serve him well, or to serve him at all. But these two conflicting interests, themselves often engaged in a life and death struggle with their own competitors, cannot take any but a strictly selfish view, and there must be a power to intervene between them, protecting them from each other, and safeguarding the public interest. Without governmental bodies of this nature, which take a judicial and at the same time constructive point of view, the only remaining solution would be government ownership and operation.

All this is so obvious that I feel like apologizing for taking your time in stating it, but if it is obvious that these bodies perform functions of the very highest importance in regulating transportation and finance, in developing equitable tariffs, and in seeking to develop ways and means by which our industries may organize for joint and effective competition in foreign fields, why, then, if this is so obvious, does business look upon the work of these bodies generally with apathy, and frequently with ill-disguised animosity?

I believe there are four main reasons:

First: We are a highly individualistic people; we cherish our personal liberty and naturally resent any kind of compulsory regulation as bothersome and unnecessary interference;

Second: There is a strong belief among American business men that they "know better," and that any government requirement or regulation is bound to be theoretical rather than practical; extreme and destructive rather than helpful;

Third: It is natural that those should be dissatisfied who in the past had a larger piece of pie than was due them, which consequently had to be cut by government interference;

And, finally, it is equally natural that those should be dissatisfied whose slice, small in the past, has been increased by the government, but who now feel resentment that they cannot have the whole pie to themselves.

We need not lose much time over the last two classes, but we may devote some thought to the first and second.

True democracy cannot resent self-imposed regulation as an infringement on personal liberty; it would be that only if it were imposed by others. We willingly accept police regulations as measures adopted by ourselves for our own personal safety. Why, then, should we revolt against regulation that deals with the much larger question of national protection?

Putting the question in this way is to answer it: "Because, in our daily life, we value our personal interests higher than that of the country."

These last months have brought us face to face with problems of extreme gravity. Their redeeming feature has been that they have awakened in us the willingness to consider our country first, and to place our personal comfort and interests where they belong—in the second row. But our lesson would be only half learned if we did not begin to apply it in peace as well as in times of stress or war.

As to the second charge that these boards are largely filled by men stronger in theory than in practice, I believe that in thinking of them many of you have in mind Bernard Shaw's sarcastic remark, "He who can, does. He who cannot, teaches."

But, gentlemen, when you consider the tremendous scope of influence the government is bound to exercise in the future business life and growth of nations, when you bear in mind that with the rapid changes of heads of departments and in our legislative bodies, these non-partisan boards and commissions may become the strongest elements of economic stability and expert knowledge, you will agree that these government boards will not be positions for "teachers," but, indeed, for real "doers."

Do not overlook that these boards will have to act as buffers and balance wheels, not only between the various business interests involved, but also between emotional and changing factional government influence on the one side and the needs of quiet and steady economic evolution on the other. Capital and labor, farmer and manufacturer, shipper and carrier, all have their spokesmen in Congress, often representing as one-sided a class view as the classes themselves. To understand all parties to the controversy, to combine the business man's point of view, as well as the farmer's, with the more detached conception of a non-partisan, expert government body; to arrive at the judicial and national point of view; to discover the proper middle course conducive to the best interests of the entire country; to prevent harmful over-regulation in either direction; to overcome mutual distrust, prejudice, and suspicion of all parties concerned, is a task deserving of the best talent and the strongest characters of the nation.

The scope of government regulation in business matters all over the world will not decrease but rather increase in the next twenty-five years. Modern states can no longer succeed without it. For us it is no more the question of whether we shall or shall not have government regulation or promotion in certain branches of our business life. The problem is to find its most efficacious form. Unless we do, we shall fail to hold our own. For us, the question is only, shall it be a non-partisan, expert regulation, or one changing with changes in party government.

That democracy is the ideal form of government I do not doubt. But Europe's recent history has borne out the experiences of 2,000 years ago: that, in the hours of greatest need, democracy is often not the most efficient form of government. That is why in the old Republic of Rome, in times of war, recourse was invariably taken to temporary dictatorships, and that is why, for certain branches of government, we now see this form of administration again adopted in Europe. Democracy is government by the people. It is the most self-respecting form of government. But, being the expression of the ever-changing will of the masses, it is lacking in stability of policy, and in continuity in office of trained men. It furthermore abhors autocratic power vested in single individuals. It believes in checking one power by another, and each man by other men, and, therefore, vests authority in groups rather than in individuals. These are conditions which cannot be avoided. But whether democracy will prove itself capable of dealing effectively, fairly, and promptly with the intricate economic problems of the modern state will largely depend upon our ability to develop to their proper degree permanent and capable expert boards and commissions, assuring that measure of stability and reasonable promptness in action without which healthy progress cannot be made.

But, gentlemen, in order to achieve that result, such boards must find an attitude of sympathy and support on the part of the country.

Business men must feel toward these boards as lawyers do toward the Supreme Court. Just as any lawyer might be expected to give up a highly remunerative practice in order to accept a call to the Supreme Bench, so the government must feel that it is entitled to ask the best business minds to serve on a supreme bench, if you please, of transportation, banking, or trade. It is true that being a member of these boards entails sacrifices of a material and, what is more, of a personal nature; but, if in England, France, and Germany the flower of the nation always stands ready to serve its government, why should our country find its citizens less ready to follow its call? Men are willing to serve their country if they feel that the sacrifice involved is commensurate with the result to be achieved and if they can count upon the confidence, the sympathy, and the support of the people. How much have business, railroad, and banking done in this respect to enhance the attractiveness of these government positions? Have they tried to do everything in their power to help in the public work and to promote a sympathetic understanding? Or have many done the best they could to belittle it, to lament unnecessary government interference, and to discourage those charged with the duty of carrying into effect the people's will?

Personally, I have no reason to complain, but speaking by and large about the general attitude of the public, I am certain that you will bear me out when I say that it has not been what it should be for the best interests of the country. It ought to be clear beyond a doubt—particularly for you business men—that the more capable the men serving on these boards, the better for all concerned; that the higher the estimation the country places on the work of these boards, the more the country realizes the importance of having the ablest men serve it, the greater will be the chance of securing and retaining for these boards the services of leaders in their respective callings; that the more capable the various interests show themselves of taking a large and coöperative point of view, the greater will be the justification for the government to fill these boards in a larger measure from their own ranks instead of seeking them elsewhere. Men who join such commissions or boards do not want empty compliments or praise. There is but one possible compensation to which they aspire, and that is success in their efforts. If the public is interested in their efforts, if it trusts them and wishes them to prevail, their battle is half won. Intelligent understanding and a sympathetic and coöperative attitude is all that they require.

May I tax your patience by illustrating these conditions in speaking to you of some problems of the Federal Reserve Board?

I have mentioned the important amendments we are trying to secure, amendments in the adoption of which every American citizen is interested and nobody more than the business men. For almost three years the Board has been striving towards the perfection of this greater financial mobilization. How many business men have followed the work of the Board; how many have raised a hand in its support? How many realize that what really caused the fatal delay in acting upon this legislation was, as we have reason to believe, a side issue bearing no relation to the proposed amendments? It was the question of whether or not there should be added to the amendments the right, advocated by a large number of small country banks, to make certain exchange charges prohibited by the Federal Reserve Act. Time does not permit me to go into the merits of the case, even though it offers a characteristic illustration of problems requiring governmental regulation.

Whether or not these charges should be permitted or refused is a matter for Congress to decide, but it does not seem reasonable that vital legislation should be withheld or delayed at this time on account of an issue which ought to be settled independently upon its own merits.

I have mentioned this incident because I have been wondering at the apathy of business men and, in a similar manner, it has been a source of surprise to me that, apparently, they have not yet fully realized that the entrance of the state banks and trust companies into the Federal Reserve System is their concern.

The exchange problem would not offer so much difficulty if it were not that the member banks feel it a hardship that they should be asked to provide the entire system of protection for the country while the state institutions not only do not contribute their share, but, in addition, are free to make exchange charges and to conduct their business as they please. The state banks and trust companies, not counting the savings banks, have deposits of about 9½ billion dollars, and outside of the System carry cash in their vaults amounting to $600,000,000. A large portion of this cash ought to be added to the general reserve power of our country.

If some of the directors or presidents of state banks or trust companies were asked by their neighbors to join in paying for a watchman to patrol the neighborhood of their private residences, would any of them say: "Why should I? As long as you, Mr. Neighbor, pay the watchman for your house, I am protected anyhow without my paying for it."

I know that a great many of the leading state bankers of the country are very sensitive about this situation. They do not feel happy about it and have made up their minds that it is the proper thing for them to come in. They would much rather be in the position of paying their share of the watchman's salary. They furthermore know that every depositor in a member bank contributes his share to the stronger protection and to the greater credit power of the country, and that their depositors will awaken to a realization of the importance of this condition. They know that in case of a real strain savings banks, trust companies and state banks indirectly will have to depend upon the strength of the Federal Reserve System others maintain for them. Some of them, doing a large acceptance business, profit every day from the acceptance market created by the Federal Reserve System, a market that has enabled the American dollar acceptance to take its place along with the sterling, franc, and mark bills in all parts of the world. But they know that entering the System means certain sacrifices in earnings, and, maybe, the loss of some interlocking directors. Yet, if that is their contribution to the rise of America's banking system and to the safety and better growth of our economic edifice they ought to be willing to pay that price. They know it and they will do it; but the president of the state bank or trust company thinks of his competitor—"Will he come in? If he will, I will."

While still a banker in New York, I once tried to get into a subway train during the rush hours. I forced my way into a crowded car, but with another man was caught between the automatic doors which would not close behind us. My fellow sufferer began to yell at the top of his lungs: "Isn't there anybody to push us in?" Well, a guard came and pushed us in. It looks to me as if there were enough in the present situation to push the state banks and trust companies in. This is a time when beyond a doubt public interest must prevail over individual advantage.

Early training in banking in Europe has inculcated in me an aversion to banking by regulation when, by intelligent voluntary action of the banks, the same result can be achieved. But in Washington I am constantly met with the view that without compulsion it is impossible in the United States to make any headway. I have been unwilling to surrender to that point of view. I liked to think of the Federal Reserve System as of a club which the strongest and best banks consider an honor to join, and not as a "club" to swing over the heads of the banks in order to coerce them into sound banking coöperation. It is a most satisfactory fact that in almost every important city some leading state institutions have come in voluntarily, and I hope that on that same plan the majority of the strong state institutions will soon follow.

The stipulations prescribed by the Board for state bank and trust company membership are most liberal and, as a matter of fact, more favorable than those governing national banks. The Board's policy has been not to restrict member state institutions in the exercise of legitimate banking powers, granted to them by their respective States, but rather to try to enlarge the powers of national banks where they find themselves at an unnecessary disadvantage against their non-member competitors.

The present condition of having 7,500 banks carry the burden for 27,000 is unfair both to the member banks and to the best interests of the country. The strong non-member banks who, knowing the facts, do not remove this inequality will, in time, force the government to do its duty in adjusting the matter. But if Congress finally should be forced to wield "the big stick," they will be the ones to complain most loudly about the "nuisance and unfairness" of governmental compulsory regulation.

Under a highly developed system of branch banking, there are in England 259 joint stock banks, in Canada 21, in Germany about 350. We have about 30,000. It is obvious, therefore, that leadership and direction by government agencies is even more necessary with us than in Europe. We have adopted from Europe the principle of coöperative protection in banking and we ought to accept from them also the loyal spirit in which they coöperate with their leaders. The people, the banks, and the press are mindful of the fact that farmer and manufacturer, borrower and lender, of necessity cannot take an unselfish point of view; that no matter how profoundly they believe they have given due regard to the country's general interests, most of them are so busy with their own affairs that they have not even had the time to consider the problem from any but their own angle. The central bank's actions must, of course, bear careful analysis and healthy public discussion. But the first impulse abroad is to follow the men they have placed in charge, to stand by them, and to take it for granted that the obvious is not likely to have escaped their attention, and that the only object in view is to be fair to all and to do the best for their country.

More than in Europe it is necessary with us that our banks shall not consider the Federal Reserve System as an unwelcome and bothersome leash from which some day they still hope to escape. The Federal Reserve Act provides for a joint administration by government on the one hand and banking and business on the other. The more the banking and business communities realize that government regulation in banking is indispensable and has come to stay, the more they substitute for a critical attitude a spirit of active coöperation, the more they begin to recognize their duties and privileges as half-partners in the administration, the more they make it their business to perfect the machinery which has been established for their own protection, helping instead of hindering those who try to make it a success, the happier and the safer will they be and the better it will be for all. Let them be clear about it that our people will never permit this Federal Reserve System, or any other similar system, to be run by the banks alone without the check and regulation of the government, just as little as the country would permit the government to run such a system without the counter-check of the coöperation of the banking and business communities. You may say that this marriage between government and business is not wedlock based upon love at first sight. But no matter whether it was love, reason, or necessity that brought it about, there can be no divorce. And inasmuch as they must live together, the only wise course is to pull together and let the common interest act as the strong bond uniting them.

And now, coming back from these illustrations taken from my own field of activity, permit me in closing to recapitulate the thoughts that I have tried to convey.

The modern State is as much an economic as it is a political unit. There are millions of individual enterprises apparently self-centered and independent, but, as a matter of fact, all dependent upon each other. There is not one in the conduct of which, directly or indirectly, the State is not interested. There is not one which, by exaggerating the single and selfish point of view, might not do harm to others and affect the well-being of the whole. Whenever the fair middle course, essential for the greatest prosperity and comfort of all, cannot be established and adhered to by common understanding between contending parties, the government has to step in as a regulating factor. If this regulation is to bring about the best results, it must not be exclusively preventive of abuses or destructive of old business practices, but it must be, at the same time, constructive. Government must not regulate only, it must also promote.

In the state of the future, particularly in Europe after the War, the most efficient government promotion of industries in many lines will be held to exist in actual government ownership and operation. More than ever before will states become solid industrial and financial unions effectively organized for world competition driven by the necessity of perfecting a system of the greatest efficiency, economy, and thrift in order to be able to meet the incredible burdens created by the War.

Such is the future of the world in which we shall have to maintain our own position, and it requires, on our part, thorough organization and steady leadership. Under our democratic system this cannot be furnished by changing party governments, but can only be provided by fairly permanent, non-partisan, and expert bodies. These bodies must combine the judicial point of view with that of active and constructive business minds. They must be able to act as expert advisers alike to Congress and the industries concerned. They must break down suspicion and prejudice of government against business and of business against government. They must stand for the interest of all against the exaction or aggression of any single individual or group, be it called capital or labor, carrier or shipper, lender or borrower, Republican or Democrat.

Our ability to handle effectually the great economic problems of the future will depend largely upon developing boards and commissions of sufficient expert knowledge and independence of character. This will be possible only if both government and the people fully appreciate the importance of such bodies, so that the country may find its ablest sons willing to render public service worthy of the personal sacrifices it entails.

I believe that the dark clouds of sorrow and suffering which for three long years have shrouded the world will before long show us their "silver lining." We shall see it in the greater political liberty and safety coming to millions in Europe. We shall perceive it in the chastening that will come to some and the awakening of others to the deeper realization of the things most essential in life. To us it will bring, I believe, a keener appreciation of the individual's duty towards his country, not alone to his country in stress, but also to his country in its peaceful endeavors. It will develop a better understanding of our common problems, and with a proper estimation of their importance there will come a greater willingness on the part of all to serve the country either by taking a more active share in its government or by readier and more intelligent subordination of our own work or comfort to the larger public interest.

This broader conception of genuine citizenship will perceive in government regulation not unwelcome and arbitrary restraint to be resented by liberty-loving men, but self-imposed rules established for mutual advantage and protection.

Aristotle, in defining the essential characteristics of liberty, said: "It is to govern and in turn to be governed," and this thought has lost nothing of its force even though 2,000 years have passed since it was expressed.

Liberty without government is anarchy.

Government without coöperation of the governed is autocracy.

To govern and in turn to be governed is the only form of true liberty.

In this conception there is nobody governing and nobody governed. We all govern and serve alike and together. We all serve one master; the only master that no liberty-loving man need be ashamed to serve—we serve our country.

JUNE 17, 1918

XXII

TRADE ACCEPTANCES

ADDRESS BEFORE TRADE ACCEPTANCE COUNCIL, CHICAGO, ILL.

FOR at least three years after the automobile made its appearance there still were men and women who argued passionately that the people who used it were snobs and murderers, and that such machines should not be permitted on the public highways. The exponents of this view, at that time, were still dealing with the automobile as with a theory; they did not realize that, while they were debating, the automobile had already proven its worth, had been definitely adopted and had begun to gain an ever-growing importance in the economic life of all nations.

I well remember that similar discussions took place concerning the Federal Reserve System during the first year or two of its operation. People were still urging that it was an impossible system conceived by theorists and doing violence to old banking practices; an expensive luxury that might be dispensed with. The men who expressed these views did not realize that, while they were protesting, the System had driven its roots so firmly into the ground that it could no longer be removed. It is now recognized by even its severest critics of the past as the backbone of the banking organization of the United States.

A similar condition prevails at present with respect to the trade acceptance. It is at this time the subject of heated debate. Some consider it impracticable and not suited for the use of American business men; others consider it dangerous and think it ought not to be encouraged or perhaps even permitted. But, as in the two cases just cited, while the trade acceptance is being discussed as a theory, it already has become a fact. The trade acceptance is here—it has proven its worth in thousands of cases, it has come to stay, and now that the first and most difficult step in popularizing it has been taken, its general use will grow by leaps and bounds.

In this discussion concerning the merits and demerits of the trade acceptance, both sides, to my mind, have made the mistake of over-stating their case. The champions of the trade acceptance are not warranted in saying that it is the only proper instrument of credit, that it should, or will, drive out rapidly all single-name paper and the cash discount system, that to use it is the highest degree of patriotism, and that to refrain from using it shows a lack of public spirit. On the other hand, it is equally unwarranted to assert that the use of the trade acceptance by the business men and bankers in the United States is impracticable, or that its adoption makes for bad and unsound business habits.

Why should anyone who sells goods for cash be expected to change his method and attempt to sell his goods on long-term credit for the mere satisfaction of using trade acceptances, unless he finds that the cash discount which he offers, in order to avoid the granting of credit, is so heavy that it would pay him better to make the change, or unless he finds that in particular cases he may render a public service by permitting his purchasers to pay by trade acceptances.

While, therefore, we readily concede that it is foolish to believe or to argue that the trade acceptance should be used in settlement of any and all business transactions, it is equally foolish to deny that hundreds of millions—some estimate billions—of dollars worth of goods are sold to-day on so-called "open accounts," and wherever that is done there can be no vestige of doubt that it makes for better business methods when seller and purchaser agree upon a definite obligation to pay on a certain date and express this in a negotiable instrument, permitting the seller to finance himself on favorable terms for the period of the credit granted by him to the purchaser of his goods.

The Trade Acceptance Council informs me that there are to-day over 4,000 firms that have adopted the trade acceptance, and the list of these firms embraces concerns of great importance as well as small houses. It includes the flour mills of Oregon as well as the lumber mills in Florida. During the last month two trades of great importance have declared themselves in favor of using the trade acceptance. The Raw Silk Trade Council passed a resolution that "On and after July 1st, 1918, all raw silk, except for transactions based upon bankers' letter of credit or the drawing of foreign drafts direct upon the buyer, shall be sold, or contract of sale made with buyers, without any exception whatsoever, upon terms of cash settlement, prompt or within ten days, or trade acceptance, if other than cash terms are agreed upon. Such trade acceptances are to be given by the buyer to the seller within not later than thirty days from date of invoice. All trade acceptances shall be made payable at a bank, located preferably at a free or discretionary point, otherwise the cost of collection is to be charged to and paid by the acceptor." The buyer is not, however, deprived of the privilege of offering cash less proportionate discount, at the rate of 6 per cent per annum, in settlement of an invoice calling for trade acceptance, but he must do either one or the other within thirty days from the date of the invoice rendered.

This change of terms is made on the ground that the adoption of the trade acceptance method of settlement will eventually work out to the benefit of both seller and buyer.

The circular sent out giving notice of this agreement is signed by thirty-six of the leading firms in the silk trades.

A highly important action was taken on June 8th at a meeting of a committee, appointed on May 4th by the National Association of Cotton Manufacturers, representing spinners, cotton shippers, and bankers. Governor Harding was present at the conference. A resolution was unanimously adopted, recommending that in addition to present facilities the bankers' acceptance and the trade acceptance be used whenever practicable and as far as possible in financing next season's cotton crop.

These developments speak for themselves.

Moreover, it is of no small significance that other countries, whose financial methods (since the adoption of the Federal Reserve System) we are approaching more and more, are using the trade acceptance almost exclusively. It is inconceivable that in these countries the trade acceptance should so excellently serve its purpose if it were really as devoid of merit as its critics assert.

About two years ago I had the honor of addressing the Credit Men's Association at a meeting in New York upon the topic of the trade acceptance, and since then so much has been said about the advantages of the use of that method of financing that it would be needlessly taxing your patience were I to undertake to demonstrate again to you that the trade acceptance, when properly used, turns a frozen asset into a liquid one, and that the firm which organizes its business on the basis of the trade acceptance is placing itself in a very much stronger position than its competitor who refuses to modernize on the same lines. It would be needless repetition were I to reiterate the other arguments with which you are familiar. It may, however, be useful to analyze this question: Why is the adoption of the trade acceptance so vigorously opposed by some bankers and business men? Let us consider first the reasons given by the bankers. Some bankers assert that in buying a promissory note the mere fact that they are conscious of buying the naked note of a customer furnishes a reason for carefully analyzing the statement of the customer and judging the merit of the borrower upon the statement of the latter's financial condition. They allege that this practice is safer than that of purchasing a trade acceptance issued by the same firm because, as they say, in that case they are likely to rely on the legitimate character of this double-name paper without examining as cautiously as they otherwise would the general condition of the borrower; the likelihood of their adopting that course, they urge, might lead to the manufacture and sale of fictitious accommodation acceptances on the part of their borrowers, and they cite experience in support of their contention.

Other bankers state with great force that they are opposed to the trade acceptance because they would not feel justified in continuing to buy the single-name paper of a borrower who has adopted the habit of selling his trade acceptances. The reason given for this view is that whoever buys a trade acceptance acquires the first lien on what would otherwise have represented one of the accounts receivable of the concern which drew the acceptance, and in addition to that lien, in case of bankruptcy of the drawer of the acceptance, the holder of that acceptance would rank equally with the unsecured noteholder as a general creditor for any part of the acceptance which the acceptor might not have paid. As you can readily see, it is impossible that both of these opposed views should be correct; one banker asserting that he will not buy trade acceptances because he does not think they are safe enough, the other that he opposes the trade acceptance because it is so good as to render unsafe the purchase of single-name paper of any customers that may have sold trade acceptances. Which of the two arguments is sound? To my mind neither. It has never been contended by the champions of the trade acceptance that these acceptances should be bought by anyone who has not familiarized himself thoroughly with the financial condition of the maker of the paper; he should take this precaution just as if he were buying a single-name note, and as long as he does that there is no reason whatever why he should not be capable of judging solvency and standing from the statement of a borrower who sells the trade acceptances he receives just as he can to-day from the statement of a firm which borrows only on its own note. Indeed—one of the main virtues of the trade acceptance is that it clarifies the statement, inasmuch as it shows on the asset side exactly how much there is available in liquid items, among which are the trade acceptances owned, against outstanding liabilities. If the borrower wishes to obtain funds on his single-name note, in addition to trade acceptances sold (which would be shown as a contingent liability), he would have to satisfy the banker that these funds are required for temporary working capital or for the purchase of material used in the process of manufacturing; unless, indeed, the borrower were paying for the purchases by giving his own trade acceptance. In the latter case the trade acceptance would show as an obligation on the liability side.

This leads us to the objection made by the banker who is unwilling to buy the single-name note of a firm which sells trade acceptances. The Canadian and European methods indicate, I believe, the proper answer. In Canada and England and on the European continent it is quite customary for banks to grant a customer an overdraft credit. Such a "line" represents the sum on which the customer may count with fair regularity. In addition to that, the Canadian bank will buy freely the customer's trade acceptances, though, of course, within given limits. Generally speaking, if the customer be strong and solvent, and if he be considered fairly conservative in choosing his purchasers, the bank will be found ready always to buy a handsome amount of trade acceptances in addition to the regular overdraft granted, relying on the fact that even in case of insolvency of the customer the larger percentage of these trade acceptances will usually be paid, the risk being so largely divided.

When our banks begin to look upon the trade acceptance from this, let us call it, Canadian point of view, I think they may well conclude that it is perfectly proper and safe for them to buy a certain amount of single-name paper (corresponding to the overdraft) and in addition to take a liberal amount of the customers' trade acceptances, provided they use care in scrutinizing the statement of the borrower. I believe many of them will be willing to admit that the flagrant cases cited by them of losses on fictitious trade acceptances were those where the bankers neglected to ask for or to insist on getting the customers' statement. It may be timely for me to add that since the beginning of the operations of the Federal Reserve System, the Board has done all in its power, by regulation and admonition, to insist on full and frank statements on the part of business firms, as well as of banks and bankers themselves. In banking and business the greatest safety lies in publicity and frankness.

I am willing to admit that I have a lingering suspicion that certain banks which oppose the trade acceptance may be somewhat influenced by the fact that single-name paper offers a better interest return than the trade acceptance. I am glad, however, to state my belief that the vast majority of the banks take a different point of view in this respect, and that to them the facts that the trade acceptance has been recognized as a preferred type of paper by the Federal reserve banks and that it has a wider and more favorable market than single name paper, are of sufficient force to make them very willing and even anxious to buy these trade acceptances in spite of the lower interest return, just as they buy, by preference, bankers' acceptances on account of the greater liquidity of the latter, even though at present such acceptances net only 4¼ per cent as against the commercial paper rate of 6 per cent or more.

Now let us examine the reasons why some business men oppose the development of the use of the trade acceptance. Some, I believe, fight it because they are jealous of maintaining their business on a cash basis—that is to say, they are willing to pay even a high premium in order to avoid the cares and risks of sales on credit. That is a question which every business man must decide for himself, and, as I said in the beginning, we should not attempt to force anyone to do anything in this respect that he does not consider to his own best advantage. It is impossible, however, for me to understand why any business man should be alarmed or excited because of the use of the trade acceptance by others who are obliged to sell their goods "on open account." Valid objections could be raised only by one of two classes of business men: weak or unreliable purchasers who object to binding themselves to a definite obligation to pay on a certain date (in which case, however, the reasons for the opposition on the part of the purchaser ought to be the very argument for the preference on the part of the seller); or certain firms of great financial or commercial strength, which desire to preserve their position of advantage as against weaker competitors. When borrowing on its own note, the strong firm, with well-established credit, can obtain larger loans and on more favorable terms than its small competitor, and it is, therefore, in position to finance its purchases and its sales on a more favorable basis than the small firm. It gains the advantage both as to the larger scope of business it can do and the lower interest rate it enjoys. True, it could probably do a larger business than at present by adopting the trade acceptance plan, but by thus adopting the trade acceptance basis small firms would probably profit more in proportion than the larger ones—their handicap would be lightened.

The general use of the trade acceptance is likely to tend towards greater standardization of banking paper and greater equalization of interest rates, and I am inclined to think that we might call it a step towards greater democracy in commerce and banking. That is one of several reasons why the Federal Reserve Board favors the policy of granting a preferential rate for trade acceptances. But, speaking broadly, the Federal Reserve System is interested in seeing the business of the country done on the soundest possible basis. Whatever makes for prompt payment may be considered an actual gain at a time when our efforts must be bent upon saving as much as possible, not only in material and labor, but also in time and credit.

It is one of the most difficult problems at this juncture when hundreds of millions of dollars have to be shifted every day, to shorten the many circles in which it travels, not only in the large operations of the government, but in every individual transaction. It is in the general interest that money paid out for wages and material return as fast as it can to the producer when his goods are sold. Pending the return of the money due to him he must rely on bank credit, which naturally is limited, and consequently he has to adjust the scope of his operations to the speed with which his "turn-over" can be completed. The trade acceptance plays a most important part in this respect. By securing trade acceptances even though he may hold them to maturity, the manufacturer can figure with greater exactness what are his obligations and his available cash assets, and, by removing elements of uncertainty, he is enabled to carry on a larger business and to do it in greater safety.

At a time when so much depends upon using every possible advantage in order to speed up production, so as to avoid an unnecessary tie-up of funds, the use of the trade acceptance may be considered a contribution to the national welfare. It must not be said that whoever fails to use the trade acceptance is unpatriotic, but it may be said that it is essential that every one do what lies in his power to remove anything that stands in the way of securing the greatest possible efficiency of our country at this time, and anything done in this direction is patriotic.

It has lately been explained to me that canneries are facing a rather difficult situation, inasmuch as all prices for cans, boxes, and wages have risen so much that during the coming canning season the credits usually available for the canneries may not be sufficient, the amount of money involved having doubled and the 10 per cent limit in many cases prohibiting the country banks from providing locally the necessary advances. In discussing this problem and trying to suggest means of relief, I asked the question, "How do the canneries pay for their cans and their boxes?" I was told that they pay cash. I inquired "Could not the can manufacturers take trade acceptances in payment for their cans?" The answer was that the can company must pay cash itself for the tin that it buys from the steel manufacturer; that possibly next year something of the sort might be arranged, but that for this season it would be too late. I did not have the time to look further into the matter, nor is it my intention to venture any opinion as to whether or not it might be practicable for these important companies to change their methods of selling their goods. No doubt they consider themselves better protected in selling for cash and probably they control the market sufficiently to enable them to insist on cash terms. On the other hand, it is clear from the situation I have described, that great relief could be given in this particular case to the canneries—provided, of course, that their credit warrants it—if they could be permitted to pay for their tins and their boxes by 90-day trade acceptances. The process of canning is so rapid that probably even a shorter term than 90 days of credit might prove sufficient. As soon as the canning process is completed, I am told, the canners are able to secure their loans by warehousing and pledging their finished product, and the difficulty of financing is overcome. But for the short period of the peak of the load the use of the trade acceptance might be of the greatest advantage to them.

Facilitating the process of manufacture of food products is certainly a service which contributes to the national interest at this time, and, while I have mentioned this case merely for the purpose of illustration, I hope that it will not be taken amiss if I venture to urge the large industrial concerns in dealing with this question not to consider it exclusively from the point of view of what is to their own best advantage, but to bear in mind that in many cases they have the opportunity of rendering a distinct service to the national interest, an opportunity which, when once clearly recognized, they will not wish to miss at this juncture.

In this connection, it may be useful to remind you of a ruling made by the Federal Reserve Board (printed in the March, 1917, Federal Reserve Bulletin) to the effect that a trade acceptance, if drawn within reasonable time after the shipment or delivery of goods, may be considered as a bill of exchange drawn against actually existing value, so that a national bank may buy such trade acceptances from its customers even after it has reached the limit of 10 per cent of its capital and surplus, which constitutes the maximum credit such bank may grant a customer on his single-name note. In view of the greatly increased price of practically all goods and the consequent larger amount of money involved in production, the facility thus afforded by the use of trade acceptances may prove of the greatest service, as you may readily see from the problem of the canneries just described.

Great efforts are being made at present to reduce bank loans as far as possible where they are made for the carrying on of business transactions not strictly compatible with the public interest—that is to say, not absolutely necessary for the successful prosecution of the War, or the health and necessary comfort of the people.

The single-name note easily serves as "camouflage." It is very difficult to trace exactly what transaction is being financed by any particular note. The trade acceptance, on the other hand, bears on its face the evidence of its legitimate character—it is capable of proving a most convincing "alibi" where there is doubt as to the purpose for which the proceeds have been used, and it may, therefore, be a great help to the banks in carrying out the national object of conserving to the utmost material, labor, transportation, and credit.

It may be proper for me to avail myself of this opportunity of pointing to the great importance to the Federal Reserve System of finding ways and means of discriminating between essential and non-essential credits. The great speed with which new dollar values are being created at this time and the enormous demand of governments for goods render it imperative that we counteract the resulting inflation of prices by setting the brakes upon every unnecessary use of credit or material. Normally these brakes would be applied by enforcing higher interest rates. In view, however, of the necessity of keeping the money market in a condition of sufficient ease to enable the government successfully to carry through its vast financial operations, it would be to the greatest public advantage if contraction of credit could be brought about by voluntary discrimination rather than by the compulsion of higher rates. May I enlist, therefore, your earnest interest and hearty coöperation in this most important phase of "war economy"?

Owing to the government's heavy demands upon the investment market it has become very difficult for industrial corporations to raise money on reasonable terms through the sale of securities. This is a source of embarrassment felt more keenly by the large corporations, which normally depend upon the securities market for their financing, than for the smaller concerns normally operating with bank credit. In consequence a good deal of pressure has been brought to bear upon the Federal Reserve Board by these corporations in order to enlist its interest in securing legislation permitting the rediscount of notes secured by bonds or stocks. The Board could not possibly favor such a step since it would tend to undermine the liquid character of the Federal reserve banks' investments; but it encouraged these corporations to study carefully the question whether it would not be possible for many of them to avail themselves of the facilities of the Federal reserve banks by financing some of their purchases or sales in the form of trade acceptances. In some cases that has been done; before long it is likely to be done on a much larger scale.

As the War proceeds an increasing burden will be placed upon the Federal reserve banks. The rapid increase of deposits and loans of the banks of the country, which we must look forward to as incidental to the unparalleled scope of war expenditures, will create a constantly growing demand for means with which to maintain the corresponding increase in the reserve balances required by law. The only reliable key to the Federal reserve banks' credit facilities is "eligible paper" and the most liquid paper which outside of the Federal reserve banks commands the widest market and the lowest rates is the "acceptance," be it the bankers' or the trade acceptance. The market for both is certain to grow in importance. On the one hand our banks, and particularly the country banks, will become regular and eager buyers as they realize in increasing numbers that instead of keeping balances with other banks they do better in holding acceptances which produce a higher interest return and serve at the same time as a reliable secondary reserve. On the other hand, several discount companies, recently established, or organizing, will prove important new factors, as purchasers as well as distributors, in widening the market for trade acceptances. A growing volume of such paper, coupled with a growing habit on the part of the banks of investing therein, will furnish an additional and most valuable element of safety in the present emergency, and it is sincerely to be hoped that the banks and the business men will join efforts in promoting the widest possible use and development of this important means of exchange.

There has been quite a prolonged discussion as to whether the community of the buyer or of the seller should carry the trade acceptance; indeed, the critics of the trade acceptance state as one of their objections that it is apt to throw the burden of financing primarily upon the seller's community. The truth of the matter is, however, that in case a wide market is developed for bankers' and trade acceptances, they will be carried by that community which is the most eager to invest its funds, be it the seller's or the buyer's community, or one that is neither the one nor the other. It is one of the main virtues of the acceptance system that it makes for greater fluidity of credit. Instead of permitting one section of the country to become overloaded in consequence of local seasonal requirements absorbing all available cash resources, bankers' and trade acceptances bring relief by flowing into discount markets of other districts where money is more plentiful. The adoption of the plan of financing the coming cotton crop largely through bankers' and trade acceptances ought to result in greatly easing the burden to be carried by the South during the coming season.

In closing, may I be permitted, on behalf of the Federal Reserve Board, to express its genuine and warm appreciation of the excellent work done by the Trade Acceptance Council. For the benefit of the country you have unselfishly undertaken a difficult task, a campaign of education, which requires energy, consistency, patience, intelligence, and tact. The trade acceptance can win only if the particular characteristics and requirements of each trade are studied carefully and sympathetically; only where a basis can be found which permits the adaptation to the use of the trade acceptance without undue violence or harm may we expect quick and permanent success. In meeting all these agencies your Council has shown itself fully equal to its task.

From experience of my own, I believe I may safely say that nobody knows better than members of the Federal Reserve Board that campaigns of education in banking exact a maximum of patience and persistence. The very experience, however, of the Federal Reserve Board will, I hope, serve as an encouragement to the Trade Acceptance Council.

There was as much active and passive resistance to the adoption of the bankers' acceptance as there now is exhibited in opposition to the trade acceptance. To-day no one doubts any longer that the bankers' acceptance has come to stay and that it has proved its worth as one of the most important media of exchange, an additional element of strength, and an indispensable component part of the vast structure of liquid assets upon the solidarity of which the safety of the Federal Reserve System and with that the safety of the country is predicated.

If the trade acceptance, in years to come, should occupy a similar position and render a similar service—as I hope and trust it will—the Trade Acceptance Council will enjoy the keen satisfaction of having done its full share in a development so greatly to the benefit of our country.

JUNE 6, 1918

XXIII

CAPITAL ISSUES FOR STATE AND MUNICIPAL DEBTS AND THEIR RELATION TO WAR FINANCING

Read at the National Conference on War Economy

INTELLIGENCE is a question of priority. It is a question of seeing a thing sooner than the other fellow. When once a thought has been clearly conceived and expressed, when once it becomes public property and is generally understood, it becomes trite and obvious. So also the winning of the War has become a question of priority.

After a four years' struggle, during which over $112,000,000,000 have been spent, the question of the original state of preparedness has lost its significance in its bearing upon the final outcome. That side, however, has the best chance of winning which, in the long run, will prove the quickest to foresee and to grasp the constantly shifting problems of the struggle and to take the steps necessary to master them, whether or not they are of a military nature. As the President said in his splendid appeal for thrift on May 29th, "This war is one of nations—not of armies." Modern warfare has become a struggle of resources and industries as much as a struggle of men, and it involves, therefore, not only the millions that actually serve in the field, but the hundreds of millions that stay at home. It means that no country has any chance for victory that refuses to organize its entire population so as to concentrate its thoughts and efforts upon winning the War. In order to triumph, the rich and poor alike must realize before it is too late that the government has the first call on our sons, our services, our goods, and our savings; that it is entitled to every available ounce of material and man power.

England began the War with the slogan of "Business as usual"; it took many fateful months until the country fully accepted Earl Kitchener's view: "Either the civilian population must go short of many things to which it is accustomed in times of peace or our armies must go short of munitions and other things indispensable to them." To-day there is no one who would take issue with Lloyd George's striking statement that "Extravagance costs blood; the blood of heroes." I believe it is freely admitted to-day that England's failure to adopt from the beginning the point of view of these eminent leaders and to appreciate at an early stage the duties devolving upon the civilian population in times of modern warfare has been the cause of loss to her of untold life and treasure. But while England was dealing with wholly unprecedented conditions, justly baffling the ablest minds, we who have the advantage of her dearly bought experience should stand convicted of a very grievous crime if we lost precious time in adjusting our minds to a full realization of our civic duties at this juncture.

In time of war nothing is more dangerous and more fatal than delay. The present emergency requires that the country be aroused to a thorough consciousness of the fact that whoever uses material, credit, labor, or transportation unnecessarily is placing a handicap upon his government in its efforts to complete its preparations as speedily as possible. Instead of aiding the government he competes with it, bars its way, and is guilty of delaying its progress towards victory.

It was for the purpose of curbing such waste of the national resources that the British established their Capital Issues Committee, and that a similar committee was organized here about five months ago. Both committees deal only with cases involving the sale, or offer for sale, or subscription of securities (any sale in excess of $100,000 in stocks or bonds falls within the scope of the American committee's operations). In so far, however, as the great national task of encouraging economy and thrift is concerned, the underlying principles are the same whether we deal with individuals, with industrial and public service corporations, or with States and municipalities, except only that those principles apply with so much greater force in the case of States and municipalities, not merely because the sums involved are likely to be so much greater, but also because the example given by these governmental authorities exercises a powerful influence—for good or for evil—in molding the civic mind. It is for this reason that I am particularly grateful for the privilege accorded me by the invitation to speak upon the topic of relations of Federal war financing to the capital issues of States and municipalities and to be permitted to address a conference which counts among its participants so many men prominent as leaders in the public life of their communities—governors, comptrollers, and mayors, whose very presence will insure the widest possible interest in the proceedings of this conference.

When the Federal Reserve Board's Capital Issues Committee, at the request of the Secretary of the Treasury, undertook to deal with the question of controlling and curtailing capital issues, it established as one of its first principles that every expenditure not strictly compatible with the public interest of the United States—that is, every expenditure not directly helpful to the prosecution of the War, or absolutely necessary for the health and reasonable comfort of the people, ought to be abandoned for the time being.[1] The Capital Issues Com-

[1] In January, 1918, the Secretary of the Treasury and the Federal Reserve Board invited the author to organize and take the chairmanship of a Capital Issues Committee the imperative need of which, as well as that of a War Finance Corporation, he had urged for quite some time. Twelve local committees were organized under the leadership of the twelve Federal reserve banks which, in turn, operated under a central committee at Washington, consisting of Messrs. Allen B. Forbes, of New York; Frederick H. Goff, of Cleveland; Henry C. Flower, of Kansas City; Paul M. Warburg, Chairman,

mittee was mindful of the fact that it was self-constituted and acting without express authority of law, and that it could secure results only by enlisting the voluntary and patriotic coöperation of all concerned. I am frank to admit that when the committee began its operations its members were not at all certain that they would not meet with determined opposition on the part of certain groups of industries which, of necessity, would be seriously affected by its rulings. It is a genuine satisfaction to be able to state that, from the very beginning, the committee met with nothing but the most patriotic response. No matter how important or vital any particular issue may have seemed to the applicant when he first presented his case, and no matter how insistent he may have been in the assertion of the prime importance of his individual requirements, nevertheless, whenever the committee, or one of its sub-committees, explained the true significance of the problem and the principles which it was necessary to apply in order best to serve the country, it never failed to awaken that finer spirit that willingly subordinates individual advantage to the national welfare. The American Bankers' Association, the Investment Bankers' Association, and the leading stock exchanges of the country assisted the committee greatly by immediately passing resolutions to the effect that their members would not place, or deal in, any securities coming within the scope of the Capital Issues Committee upon which it had not first favorably passed. The committee was also greatly helped and encouraged by the fact that the authorities of some leading communities promptly made it known that they would do everything in their power to coöperate. As soon as the committee was organized the Honorable A. J. Peters, Mayor of Boston, visited it in person in order to determine in what manner he might best assist its work. In his

and Stephen L. Selden, Secretary. It is to the activities of this volunteer committee, later on superseded by one formally created by the War Finance Corporation Act, that this address refers.

inaugural address, delivered on February 4th, he set forth principles that have already proved an inspiration to many, and will continue to guide many more. He stated:

> The gigantic task which we are called upon to perform is one which requires the mobilization of all our resources, material and moral. We cannot all of us fight for democracy on the plains of France. We can all help win the battle for democracy by our loyalty and sacrifice at home. To be effective the national government must have the coöperation and support of every unit of government, State and city. The great municipal agencies must shape their policies to strengthen and support the central power.
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> The support which our municipality pledges to the national government can nowhere be more effective than in the field of finance. The enormous and imperative needs which the national government must meet by the sale of bonds require that the competition in the sale of securities by other agencies should be restricted as far as possible. The Federal government is entitled to the first call upon every dollar available for investment, just as much as it is entitled to the first call upon every man available for military service. Local bonds must necessarily compete in the market with national securities, and their issue, therefore, should be restricted to the lowest possible amount.

Early expressions of this character were invaluable because it was fully recognized by the committee that it had no power of law whatever to restrict or interfere with the rights of States or municipalities to raise funds for any purpose they desired, and that only by enlisting their voluntary coöperation could it hope to obtain the best possible results. This is true even though it was realized that the pledge of the stock exchanges and issuing houses was likely to be a very important factor in securing the coöperation of the few who might otherwise have been unwilling to join in the general effort to conserve the national resources.

The War Finance Corporation Act, which gives to the Capital Issues Committee legal standing, continues to preserve this voluntary character. The bill, as originally introduced, vested the committee with power to punish those who would not submit to its rulings. Congress, however, in eliminating this provision, expressed the conviction that it was safe to rely upon the patriotism of the people of the United States to coöperate of their own accord without the threat of punishment, just as the British coöperate with their Capital Issues Committee, an organization which likewise depends entirely upon voluntary support.

In dealing with States, municipalities, or counties, the Capital Issues Committee considered mainly expenditures for the following purposes: hospitals, schools, sewers, filtration plants, municipal buildings, electric light plants, roads, parks, and bridges.

When considering applications of this character, the committee made it a rule to seek advice from the Federal department boards and commissions having particular knowledge in the premises, for the purpose of determining whether or not the expenditure involved was essential for the successful prosecution of the War, or for the health and necessary comfort of the people. Except when acting upon securities issued for the purpose of providing funds for the renewal of maturing obligations, only those cases that were found to be compatible with the public interest, as above defined, received the approval of the committee. In reaching its conclusions it observed the broad principles that the use of capital, material, or labor could be justified only where results could be expected within a very reasonable time. Thus, applications for roads were acted upon favorably only when it was satisfactorily established that they were of military importance, leading to camps, docks, or shipbuilding plants, or establishments producing materials necessary for the prosecution of the War, or whenever they were shown to be important from an agricultural standpoint in order to open up agricultural districts or to make their products available for ready distribution. In the case of schools and hospitals the committee sought the advice of the Commissioner of Education or the Surgeon General as to whether or not new buildings were absolutely required and if so whether or not temporary buildings could be used instead of permanent ones, as temporary buildings absorb less material, less labor, less transportation, and less money. Monumental buildings and parks or bridges merely involving greater comfort or luxury were disapproved. In many instances the comptrollers of certain cities and States consulted with either the central committee or the sub-committee of their district, discussing their budgets item by item, and almost invariably these conferences resulted in the elimination of unnecessary expenditures and a substantial reduction in the estimated appropriations. It is a great satisfaction, therefore, to have this opportunity of publicly expressing appreciation of the splendid spirit of patriotism shown by these State and municipal administrations.

This leads me to the complex question of the relationship of the State and municipal governments to their various public service properties. Almost everywhere there are outstanding at this time franchise and contractual obligations for the building of new subways and surface car lines, or for the furnishing of additional supplies of water, electric light, power, heat, and gas. In the majority of these cases the national interest at this time requires that every effort be made to reach an understanding by which such construction may be postponed unless indeed it serves the successful prosecution of the War and the health and necessary comfort of the people. We need the men and the steel to build our ships rather than to build new subways. We need the coal and electric power to drive the wheels of our war factories rather than to give more light for advertising displays or for other non-essential uses. To a certain extent it is true that this new construction is being restricted by the Priorities Division of the War Industries Board, which controls the sale of articles such as steel and copper so as to prevent their being employed for purposes incompatible with the public interest. But for both the Priorities Division and for the Capital Issues Committee it is a difficult task to deny the use of these materials, or the necessary capital, where it can be demonstrated that by reason of such denial the companies affected may be embarrassed to the point of defaulting on their contractual obligations. I hope it will not be considered presumptuous on my part if I venture to urge that all State and municipal governments do their utmost wherever possible and practicable to find a modus vivendi for their public service corporations and help them to reach agreements whereby onerous or unnecessary contractual or franchise construction obligations may be waived or held in abeyance at least for the period of the War. In doing this they will effectively support the work of the Federal government. Irrespective of the release of labor and material involved, it is obvious that the community itself will best be served by postponing as much work as possible until a time when prices will be lower and when, in addition, there will exist the need of finding employment for the surplus of labor which may be expected upon the termination of the War.

The drastic shrinkage in the value of public utility investments and the impairment of the credit of these corporations is a source of grave danger to the general financial situation at this time. We need the savings of the investor and it would be a serious menace to the ability of the government to finance the War if public service corporations, strong and solvent before the beginning of the world conflagration, should be forced to go into receivers' hands because of conditions for which they are not responsible. Their credit must be maintained both on account of innocent investors and on account of the necessity of preserving the physical development of corporations whose operations are needed on account of their direct and indirect effect upon the successful prosecution of the War or the health of the people.

Franchises in many cases have become excessively onerous for such corporations, due to the fact that labor, coal, steel, and copper can be secured only at exorbitant prices, while the charges for services rendered often cannot be properly adjusted without the consent of the community involved. The President, in his letter to Secretary McAdoo, dated February 19, 1918, expressed his profound concern over this situation, stating at the same time that he hoped that State and municipal administrations would make every effort to deal with these corporations in a spirit of liberality. All that it is proper for me to do, therefore, is to emphasize the public interest in the protection of the credit of these corporations and in the preservation of their ability to perform their important functions.

When the old Capital Issues Committee first undertook its work it arranged for a conference with public service commissioners representing various States of the Union. The committee was delighted to find that these State commissioners were not only open to the suggestions made by the Committee but that they were in fullest sympathy with its program and eager to coöperate in every possible respect.

It is gratifying to note that a number of leading municipalities, after a careful study of this problem, have since decided to make such equitable adjustments as to enable their public service companies to weather the storm, and it is hoped that their example will be emulated all over the country.

The thought may have occurred to many that the War Finance Corporation has been created to cope with this very problem. Without attempting to speak for the War Finance Corporation and restating only what its directors have publicly expressed, I may say that this Corporation, in the majority of cases, expects to deal only with concerns that are solvent and able to provide a bankers' guarantee. The amount that may be advanced without that guarantee is strictly limited by law and it is safe to assume that, except where the public interest absolutely requires, the Corporation will not consider itself warranted in making advances to companies on the brink of insolvency. Therefore, where advances from the War Finance Corporation are to be sought, it appears advisable that the communities involved should first do their share in placing their public utility companies on a basis upon which they may be at least self-sustaining.

It cannot be denied that State and municipal authorities enforcing economy are often faced with a difficult task. At times it may be very hard, indeed, to resist the local clamor for improved public service and the pressure brought by those interested in the granting of new contracts. Such cases have come before the committee. There were instances where the necessity for new roads was not so urgent as the desire of the contractor to secure the work, and in some districts architects or builders were more anxious than conscientious public authorities to build schools. In those cases, the support given to the local authorities by the committee often was of the greatest value to them. The Federal Reserve Board's committee was always ready to shoulder the responsibility of protecting the national interest or to take upon itself any blame for the consequences of its action. I am quite certain that I am expressing the views of the new Capital Issues Committee in saying that it will continue to proceed on the same lines. May I urge, therefore, that State, county, and city officials avail themselves of the services of the Capital Issues Committee in the freest possible manner? It is very important that this should be done, not merely when the securities are about to be issued, but especially before the expenditures and the contracts are authorized. It may be embarrassing for the Capital Issues Committee to decline approval of an issue contemplated for the purpose of liquidating a banking obligation previously incurred, except indebtedness incurred prior to

April 5th, 1918, in accordance with the provisions of Section 203 of the Act of April 5th, 1918; but you can readily see that if the committee did not stand ready to disapprove bond issues to be made in liquidation of a banking debt previously incurred for some purpose incompatible with the national interest, some corporations and municipal authorities might soon adopt the practice of first creating the debt and then forcing the hand of the committee.

Curtailment of expenditures involves automatically a proportionate reduction in the amount to be raised by the sale of securities, and to that extent it means that local administrations refrain from competing with the Federal government for the savings of the people. I need not enlarge on that important point except to say that if at present it is proper for all corporations to avoid this competition with the government, there is all the more reason for States and municipalities to do so because the majority of the securities sold by them are exempt from Federal taxes. The Federal government, instead of continuing to issue 3½ per cent tax-exempt bonds, has adopted the policy of selling 4¼ per cent bonds only partly tax-exempt, and is willing to pay the higher interest rate for the purpose of keeping as unrestricted as possible its field of comprehensive taxation. While I do not question the legal right of the States to issue tax-exempt bonds, we must recognize that to the extent that a State issues such tax-exempt securities, it deprives the Federal government of the taxing power so essential for the public welfare in this emergency. All the more sacred, therefore, is the obligation imposed upon local governments issuing such tax-exempt bonds not to authorize any issues except those absolutely necessary for the immediate welfare of the community.

May I, in passing, dwell upon an additional reason why it is of the utmost importance to reduce to the minimum the issue of securities at this time? It is on account of their bearing upon "inflation," a problem with which it is impossible for me to deal exhaustively within the limits of this address.

The pernicious consequences of inflation are a rapid increase in prices, and a corresponding decrease in the purchasing power of money. As the increase in prices progresses, the amount that governments must borrow grows correspondingly. It becomes a neck to neck race between a fictitious wealth and a reduced value of what that wealth can buy in labor and in goods. It must be our aim, therefore, to restrict inflation to the smallest possible scope compatible with the achievement of our national purpose—the successful prosecution of the War.

From an economic point of view, it is considered unsound and unbusinesslike for any one to issue his obligations for things of no permanent value. No corporation would think of issuing bonds against the coal that has been consumed in producing its finished article or against wages that have been paid; nor would you or I, at the end of the year, treat as an asset the food that we have eaten or the suit of clothes that we have worn and thrown away. That, however, is what all belligerent governments are doing and what, under present circumstances, they are obliged to do. This process must lead to economic disaster wherever the waste of the government is not counterbalanced by increased economy on the part of the people. We must bear in mind that the production of permanent values in normal times is accompanied by a certain amount of necessary and unnecessary wastage, such as the consumption of goods, food, and clothing, in quantities beyond what is necessary for the production of the commodity, and expenditures for comfort and luxuries. The necessary material and labor put into the article produced, plus the incidental wastage of goods, and plus a reasonable profit, constitute in normal times the value of the properties added to the assets of the world. This normal wastage must be reduced as the abnormal wastage of the government increases. If this policy is carried out consistently the speed with which inflation proceeds is thereby reduced proportionately.

To sum it up in its simplest form: on the one side of the balance sheet of the world corporation are all the things unconsumed; on the other side are the dollars. If the dollars increase rapidly and if the "things" do not increase—or if indeed they decrease—in quantity, there must ensue inflation of prices. The means to counteract inflation are, therefore, on the one hand, increased production and decreased consumption of "things" and, on the other, a slowing down in speed and volume in the creation of new dollars in the form of new securities, currency, or credits. The more we save, the more do we increase the quantity of "things" on the one side of the ledger and the more may we hope to succeed in keeping their price down, decreasing thereby the amount of new dollars to be issued in payment. It follows that inflation is not a question merely of banking or currency, but fundamentally a question of saving.

The duties of the State and municipal governments with respect to this great national problem are easily perceived from the foregoing. By curtailing expenditures to the utmost, they not only conserve to that extent goods, labor, and transportation, and make the savings of the people available to the Federal government, but in addition they avoid the guilt of becoming factors in the further increase of prices and of aiding the process of inflation through the issue of additional securities.

There persists in the minds of many people some hesitation to coöperate without reserve in this effort of saving, because they fear that consistent saving and curtailment of credit may create great hardships and subject many people to the cruelties of unemployment. I am profoundly convinced that we have no right to let this thought prevent us from going the full length in our drive for economies. When we have under serious contemplation the withdrawal from peaceful occupations of between two and five million men at a time when the country is in urgent need of such immense quantities of goods that our mind is not capable of picturing them, and when it needs these goods with the least possible delay, fear of serious unemployment need not be entertained. It is true that for some time to come there must be a continuous shifting of men and women from one occupation to another. When there is a shortage of thousands of carpenters in the shipyards, farm hands, who are generally trained to tinker with all kinds of arts and crafts, will be drawn into these yards and their places in turn will be filled by other classes of day laborers. If the women should decide, as I trust they will, to spend less than in the past upon all kinds of fineries, some girls may lose their places as dressmakers and seamstresses, but, as a result, there will be found large numbers of them running elevators, or doing clerical work, or serving in munition factories. No doubt there will be temporary and unavoidable hardships connected with this shifting process, but this is one of many sacrifices that we must be willing to bear. Organized labor realizes these conditions and the members of the Capital Issues Committee who met with representatives of their organizations were deeply impressed by their patriotic, courageous, and statesman-like point of view. At the same time the Department of Labor is trying its utmost to complete its machinery for directing and assisting in this readjustment of occupations while other agencies of the government are devoting themselves to the task of guiding industries away from the production of less essential to essential goods.

Nothing can be more detrimental to the successful accomplishment of our industrial war program than the effort to leave undisturbed the industries that cater to the extravagant tastes of all classes. The argument that it is necessary to keep on selling luxuries in order to finance the War is too preposterous to be considered seriously. In times of war we do well to remember the wise expression of old Diogenes, who said: "How many things there are in the world that Diogenes can do without." That applies to the life of the individual as well as of the community as a whole. The people of the United States who stand ready to give their all to win this war will cheerfully forego unnecessary comforts and luxuries when once they fully grasp the real significance of economy in this emergency. If they have not yet begun to do their full duty in saving, it is only because they have not had it sufficiently impressed upon their minds that saving is not a petty matter but that there is glory in saving, that saving has an immediate bearing upon the question of victory and defeat, and of life and death, and that at this time it is the biggest contribution the civilian population can make. We must train ourselves to visualize the cumulative result of individual and communal thrift in the light of which the smallest contribution assumes its true importance. It is not difficult to wear old clothes instead of ordering new ones when we impress it upon our minds that (our factories being busy day and night in producing the things needed for the War) there are available only few goods which can be sent to Argentina in payment for her wool; that we have no ships to spare, nor gold; that we—that is, the group of Allied powers—need Argentina's wheat and meat and wool, or Chile's nitrates or Peru's copper; that through our being short of goods to sell to neutral countries, the value of Allied currencies as reflected by the exchange rates in neutral countries has depreciated so seriously that we can continue extensive purchases in neutral countries only to the extent that they will grant us loans to cover our debit balances. It is true that most of these neutral countries are as anxious to sell their goods as we are to secure them, or even more so, and that, therefore, these neutrals are as vitally interested as we in bringing Allied exchanges back more nearly to normal rates and in granting us credits that will enable us to buy and pay for their goods. But in the nature of things, these credits must be limited by the amounts that these countries can afford to loan and, as far as short loans are concerned, by the maximum amount which we may safely obligate ourselves to release to them in gold upon the conclusion of peace.

It is impossible within the limits of this address to give a full presentation of the many phases of this question of foreign exchange. Suffice it to say in this connection that in saving goods we accomplish three things—first, we decrease the volume of things we must import; second, we increase the volume of things we may export in payment of imports; and finally, even though present lack of transportation facilities may serve to prevent us from shipping all available goods, we nevertheless accumulate a most valuable reserve stock of raw materials and finished products. If Joseph could return to-day and foretell the future to Pharaoh, he would predict that at the end of this war there will be a great famine of raw materials and he would urge those in power to acquire and store up whatever surplus of foodstuffs, cotton, or other similar raw materials the country might be able to save and accumulate. As far as our own position is concerned, such reserves of goods will prove of the greatest value during the War in adjusting our foreign balances, and a most effective protection for the coming period of the after-the-war trade struggle. *Whoever controls the raw materials will hold the key to commerce and finance*, not only because he who can sell goods need not send gold, but also because control of raw materials will give an invaluable advantage to the manufacturer competing in world markets. Our gold reserve at this time is the financial backbone of the Allied cause; let us add to our "gold" reserve a "goods" reserve. Maybe that Joseph would add this further admonition: that the necessity for saving will not end immediately upon the conclusion of peace, but that for years thereafter thrift will remain a national requisite to be practised as scientifically and as cheerfully as was our far-famed extravagance in the past.

It is impossible to do justice to the topic allotted to me without demonstrating as vividly and as convincingly as possible the all-importance of individual and communal thrift and economy for the present and future welfare of the country. The bigger the lines on which we conceive this problem, the easier will it be to arouse the entire country to support the United States in the accomplishment of its difficult task.

Owing exclusively to the iron pressure of necessity caused by the British blockade, and to the consequent enforcement of a rigid system of rationing, Germany has been able to perfect a plan of complete industrial mobilization and of the greatest possible individual and collective thrift and economy. If it is true that "intelligence is a question of priority," we may say with equal force that "priority is a question of intelligence." Shall we be able to see soon enough in what respects we must give the government the right of way? Shall we be able to see our duty clearly enough to perfect this great plan of conserving our natural resources by creating our own voluntary blockade around extravagance and waste? Can we coördinate by voluntary agreement all the independent forces of State and municipal administrations, so as to secure the efficiency of autocracy under the flag of democracy? It is a difficult task, but one that is beautiful and inspiring, and when once our people grasp its full meaning, they will never let go until it is accomplished.

Nothing will have a stronger effect in molding their minds than the sight of their own authorities restricting public expenditure, and denying public comfort, for the greater benefit of the nation. Individuals will save in the small things when governments demonstrate their determination to save in the big ones. If governors and mayors and those who share with them the responsibility of administering our commonwealth, instead of permitting themselves to be placed on the defensive by apologizing for savings effected by them, will make themselves bold and enthusiastic leaders in this movement, inviting the people to coöperate with them to the utmost of their ability, we shall have taken a long stride toward winning the War.

CAPITAL ISSUES COMMITTEE OF THE FEDERAL RESERVE BOARD—SUMMARY OF ISSUES ACTED UPON JANUARY 12 TO MAY 17, 1918

	Municipal	Public Utility	Industrial	Total
Amount considered..	$86,878,512	$172,069,605	$219,510,269	$478,458,386
Amount disapproved	19,791,665	6,000,000	39,900,000	65,691,665
Aggregate approved.	$67,086,847	$166,069,605	$179,610,269	$412,766,721
Less "refunding"....	21,392,312	125,860,284	111,411,900	258,664,496
Aggregate new issues	$45,694,534	$40,209,321	$68,198,369	$154,102,224
New issues last year, same period......	108,952,865	07,504,075	287,754,684	504,211,624
Analysis of new issues approved:				
Amount of original applications......	$65,486,199	$46,209,321	$108,098,369	$219,793,889
Amount approved...	45,694,534	40,209,321	68,198,369	154,102,224
Curtailment effected	$19,791,665	$6,000,000	$39,900,000	$65,691,665
Analysis of applications informally discouraged:				
Number...........	8	3	6	17
Amount...........	$8,915,000	$7,360,000	$3,590,000	$19,865,000

PART TWO

SERIES B

DECEMBER 6, 1918

XXIV

SOME PHASES OF FINANCIAL RECONSTRUCTION

ADDRESS DELIVERED UNDER AUSPICES OF THE CHAMBER OF COMMERCE OF THE UNITED STATES AT ATLANTIC CITY, N. J., BEFORE THE WAR EMERGENCY AND RECONSTRUCTION CONGRESS OF WAR SERVICE COMMITTEES OF AMERICAN INDUSTRIES

"FINANCIAL RECONSTRUCTION" is a subject that appeals so strongly to our hearts and minds—and to our imagination and ambition—that an invitation to deliver an address upon the topic was bound to meet with a most willing response on my part. The undertaking appeared all the more enticing for the reason that there is not likely to be found in the United States a group of men more deeply interested in the problem and more capable of approaching and furthering it on broad national and international lines than the one assembled here to-day.

But it is the impressive competence of this conference and the immensity of the problem that make me realize very keenly my own inability to deal adequately with the allotted task. As destruction once begun on the battlefield spread its waves until its effects had reached all parts of the world, so the work of reconstruction will involve the whole globe far beyond the centers originally affected; and as the character and extent of the disturbance differ in each country affected, so the word "reconstruction" will have a very different meaning in the various parts of the world. In some it will indicate the physical restoration of the tangible things actually destroyed, in others financial or commercial rehabilitation, in others it will mean the reëstablishment of normal levels of living and working—a return, more or less, to pre-war conditions. The last named group includes the United States. Considering the question merely from the domestic point of view, "the movement back to normal" would appear as the main aim and characteristic of our own problem of reconstruction.

Several thoughts, however, will at once occur to us at this point and emphasize the complexity of our task.

First: That the normal of the past is not likely to be the normal of the future, which raises the further question of what that normal ultimately will be.

Second: That between our present level and that of the future there will of necessity be a period of transition—which raises the question of how long or how short it should be.

Third: That both on account of the moral obligation involved and on account of the effect that reconstruction in other countries must needs exercise upon our own future economic and financial development, we cannot possibly consider the problem as a purely domestic one—which raises the question of purchases on credit by foreign countries and the influence of foreign purchases upon the course of prices.

And finally, that the return to the new normal level must not be construed simply to refer to the level of prices and wages, but that it includes the new norm of government influence in business—which raises the question of the restoration of the freedom of individual action and operation, willingly surrendered in the face of war, but held sacred and inviolable in times of peace.

To sketch the problem in its vast outlines is to acknowledge our inability to treat it adequately even within the limitation of some of its phases. For it is evident that the plan to be applied in grappling with the side issues must depend upon the general policy ultimately to be adopted by the government in dealing with the whole problem. That is the reason why in discussing the topic of financial reconstruction only the obvious can be stated with confidence at this time, while wide room is left open for assumptions and speculation, whenever we try to go farther afield.

If in spite of these difficulties, I had the courage to accept the invitation to speak to you to-day upon some features of the financial side of the question, my justification was the belief that by carefully analyzing the problem we may assist in clarifying it, and succeed in disposing of some of the fallacies befogging the issue.

In looking into the future we have as yet no definite landmarks upon which we can fix our range-finders in order to ascertain just where the line of demarkation will lie between the transition period and the era following it. We know, however, whence we came, we know our present conditions as our actual starting point, and it must be our first aim to try to gain as clear a perception as possible of our ultimate position, so that in dealing with the interval and the correlated problems, we may map out a course that will lead us towards that final goal. Let us begin then with the obvious things that we may be able to discern distinctly.

As I look through the telescope into the period following that of transition, I see a United States to which the world at large will be heavily indebted, and to which annually hundreds of millions of dollars will be due as interest on loans extended, in addition to the hundreds of millions due in payment of the raw materials we shall be able to spare for other countries. I see an industrially highly developed country which, with the exception of a limited number of articles, will be capable of producing most of the necessaries of life for the consumption of its own people.

I perceive, therefore, a country amply protected by a vast annual international credit balance, a country which by keeping some portion of its foreign security holdings in the form of reasonably short obligations, should be able to protect itself against any serious encroachment upon this creditor position;

a country owning a huge gold stock—a country, in short, which need not give itself any great concern with regard to the task of maintaining the parity of the dollar exchange all over the world.

I do not wish to pose as what the British wittily have termed a "war prophet-eer," but I much misread the future if it does not have in store for New York the position of a world exchange center, vying with London as a free gold and discount market. As I see it, our future economic position will be of such strength that it will be difficult for many countries to keep their exchanges at par with us. They are not likely to have sufficient quantities of the goods required by us, nor will they have large amounts of gold to spare, and therefore, in payment of the things we sell them and of the interest they will have to pay us, they will have to try to find something else than goods that we may purchase from them; that is, they will offer us the individual or collective obligations of their nationals, or their industrial enterprises, or such securities or assets of other countries as they control. If we want these countries to continue to be able to buy our goods, it is incumbent upon us to prepare ourselves to grant these foreign credits and to buy and assimilate these foreign assets.

In order to carry out this program several things are necessary. First, our banks and bankers must be able and willing freely to extend their acceptances for the financing of the world's trade.

It is inevitable, if our banks and bankers continue to show the same spirit of enterprise and patriotism they have demonstrated during the War, that in the financing of the world's current trade we shall have a very large share. As a matter of fact, we owe it to the world to bear a substantial portion of this burden. To that end the discount rates of the Federal reserve banks and the policy of the Federal Reserve Board with respect to acceptance transactions must continue to be liberal. I can well forsee the time when American dollar acceptances will be outstanding to the extent of more than one billion dollars in credits granted all over the globe.

Three years ago, when it was my privilege, as a member of the International High Commission, to visit South America, I found that the banks in that hemisphere hardly realized that there existed such a thing as dollar exchange or an American bankers' acceptance, and our own banks and merchants had to be coaxed into using them. Now these acceptances are well known and eagerly sought all over the world.

And as our banking power and machinery develop, there unfold new opportunities for foreign branches of American banks. There are to-day about fifty branches of American banks in foreign countries, besides a considerable number of affiliated banks and sub-agencies largely in Latin American countries, and more are being opened every month of the year. You are familiar with the names of the banking institutions engaged in these foreign enterprises; the Federal Reserve Bulletin in its recent numbers has given the fullest data concerning their operations. They are covering at present almost every country in South and Central America, they have penetrated the Philippines, Japan, China, and India, and we find them established in England, France, Italy, Spain, Belgium, and Russia.

But while much has been accomplished as a beginning, while the marvelous strides that our banking system has made during the War are as unparalleled as the rapid creation, equipment, training, and transporation of our armies, more remains to be done. While it is most satisfactory to note that several discount companies and acceptance corporations have been organized, it is my belief that the future will show a very distinct need for a larger number of acceptance corporations.

As the Liberty Loan bonds are absorbed by the public and as the paper secured by these bonds and rediscounted with the Federal reserve banks is liquidated, the enormous resources of the Federal Reserve System will become available for regular investment in bankers' acceptances to a larger extent even than in the past, and will prove a tower of strength, protecting our discount market at rates which will compare favorably with those of the strongest among the old established countries.

These conditions are likely to bring about a constantly growing demand for American acceptances, and I hope that not only banks and acceptance corporations, but also private banking firms will energetically cultivate this new field of enterprise. As is well known, private bankers were pioneers in England in developing the foreign acceptance business.

The War being over, it is now the privilege of our bankers and financiers to make themselves generals in the arts of peace, and to call out as volunteers the best talent, now happily again available, for the constructive pursuits of commerce and trade in all parts of the world.

There is in this call no challenge to England; she will, I am certain, retain her logical and traditional position of a world center of commerce and finance. Moreover, once we return to the time when trade between nations is no longer financed by the issue of government bonds, the old machinery of bankers' acceptances and investment banking will be so heavily taxed in both countries that England and the United States, soon to be joined, we all hope, by France, will be only too glad to find partners with whom to divide the burden and, rather than envious competition in securing the load, there will be a tendency of wishing to place a fair share of it on "the other fellow." No doubt some of the neutral countries, whose financial strength and independence have greatly increased during the War, will play an important rôle; while Germany's place as an international banker will have to be considered as vacated for some time to come.

Bankers' acceptances, however, while important factors as temporary equalizers of international balances, and invaluable, furthermore, in their incidental effect of creating centers to which other commercial and financial transactions will naturally flow, cannot be expected to offer the proper medium for settling the vast permanent indebtedness to us which we expect to see accumulating from year to year. These large balances must be offset not by temporary credits, but by an outright transfer to us of foreign assets. This may be brought about essentially in the following ways:

1. The debtor country may sell to our government its own government obligations (our government in turn financing itself by the sale of United States Government bonds substantially in the same manner as adopted in financing our Allies during the War); or

2. The debtor country may sell to our investors (instead of to our government):

a. Its own government obligations, or

b. Industrial stocks or bonds originating within its own boundaries, or

c. Stocks or bonds owned by it but issued in other foreign countries.

The first method is not likely to be employed extensively beyond the beginning of the transition period. The other three methods are the ones that in the long run we may expect to develop as the most practicable and for which we must prepare ourselves.

In order to bring about in the United States the successful absorption on a large scale of foreign securities, it is necessary that our investing public be educated properly to appreciate these foreign investments. That will only be possible as our banks and our business men going into foreign countries bring back to the "folks at home" frank and reliable information concerning the risks and chances of the proposed investments, concerning the resources of such countries, the character of their people, and their political and economic conditions.

Intimate commercial relations with foreign countries create the atmosphere of understanding, interest, and sympathy which alone renders possible comprehensive international financing; and, inversely, it is such financing that encourages the growth of trade relations. There is a relationship of close mutuality between business man and banker in this respect. For the fullest success one is dependent upon the other, and the country at this juncture depends upon both.

To go out into the world, to study foreign conditions, to open new avenues of commerce and finance, and to develop in this country a group of men whose word and judgment with regard to foreign enterprises we shall willingly trust, is a national enterprise that should appeal to the ambition and public spirit of the ablest of our coming bankers and business men.

In times of temporary adverse trade conditions or unexpected emergencies, the ownership of foreign securities is, moreover, of the greatest value to a country. We need only think of the invaluable source of strength they proved to be to England during her hours of trial. I believe we may safely say that it was the use of these foreign holdings (North American and others) that enabled England to finance her own foreign purchases and those of some of her Allies without breaking the rate of exchange of the pound sterling during the first period of the War. But from this episode we should draw the lesson that the advantage of holding foreign securities consists to no small extent in the ability to sell them in several markets; and in creating a market here for foreign securities we ought to remain mindful of that fact.

Before 1914, the large holdings of American securities in Europe and their wide market on both sides of the ocean furnished an important instrument for equalizing temporary debit balances by the so-called "arbitrage" of securities. The back-flow of our own securities must have destroyed very largely these economically important pre-war conditions. We can well imagine that government bonds with international markets will play an important rôle in restoring the basis for an easy exchange of securities, that is, a healthy trans-Atlantic bond arbitrage.

In going into these new fields of foreign investment and trade, let us start out with a generous, sympathetic, and receptive mind; with open purses—but also with open eyes and conscious of our serious responsibilities in the matter.

It is unfortunately true that wherever the faithful pioneer goes, there also migrates the crook. In opening the markets to foreign financing, almost every country fell victim to the occasional robberies perpetrated by reckless promoters. The local knowledge of American business men and bankers living in these foreign countries may prove an invaluable protection in scrutinizing these propositions. But, if I may be permitted to express my thoughts in the premises, I believe that for the better protection of both the public and the careful and self-respecting banker, it would be advisable to establish some generally accepted rules governing the information to be contained in a prospectus offering for sale foreign securities. Every great international market enjoys such rules, established either voluntarily by the stock exchanges or prescribed by the government.

If we are to be a world center of finance, as I am profoundly convinced we shall be, I believe we ought to take steps that will give to the American prospectuses the same standing and prestige as is enjoyed by those of the leading European markets. I can well imagine that by common and voluntary agreement some sort of a future capital issues committee might be organized in each Federal reserve district to give its stamp of approval to every such prospectus before the quotation on the stock exchange be granted or the public offering be made.

Such approval would not signify passing upon the intrinsic merit of the security involved, but it would give assurance that all essential facts, and nothing but authentic information, are contained in the prospectus and that they are stated over the signatures of the borrowing government or corporation and the issuing house. This is, as a matter of fact, no more than a responsible issuing house would observe. It would be a burden, therefore, only upon less conservative firms, upon which a check ought to be exercised. While, no doubt, some red tape and delay would be involved in such a proceeding, it would in the long run prove well worth while to submit to it. The chairman and governor of the Federal reserve bank of the district might be invited to head the committee, as at present. They and others would, no doubt, be found willing in the general interest to shoulder the burden.

When the present Capital Issues Committee in due course, by the expiration of the Act, discontinues its operations, it is possible that such new local capital issues committees might exercise a very important function in protecting the country in this further respect. Issuing houses in Europe do not generally enter into contracts for the purchase of foreign securities without first inquiring at their headquarters whether or not such issue is in the public interest. It must be borne in mind that when such loans are made, not only the relationship with the borrowing country must be considered, but also the condition of the lending country as a whole. Excessive foreign loans may at times adversely affect the entire network of trade balances, exchanges, and interest rates, even though the transaction may be of great advantage to particular industries, and even though the contracting country itself may be heavily in our debt. The situation as a whole, therefore, should be carefully weighed in such cases by the Federal Reserve Board which, when approached through the local capital issues committee, would give its advice.

It may be timely to point out in this connection that foreign bonds payable in several currencies would prove of great value in times when gold exportations might become imminent in consequence of unexpected temporary financial dislocations. In such circumstances interchangeable international bonds could well be sold abroad in order to replenish our foreign balances, warding off to that extent exportations of gold.

In sketching this program for the future we cannot be unmindful that, in certain important respects it will not meet our immediate needs, because it will take time to develop in the United States as wide a market for foreign securities as is here contemplated, while most urgent demands by foreign nations are near at hand. We know that almost all European countries for a prolonged period will require food, or steel, or copper, or cotton, or machinery with which to rebuild their life and industries. Many of them at present have neither gold nor goods with which to pay us. Individual and banking credit in some cases has been seriously affected, and in others has not yet had sufficient time to establish or reëstablish itself. Without doubt we shall consider it our proud privilege to give whatever we can spare to those that deserve our aid, particularly to those who, like France and Belgium, have an undoubtedly valid moral claim on us, and to that end we shall have to continue to reduce our own consumption to the necessary degree.

It is at this point of our consideration, however, that our ship strikes a fog bank and that we shall have to feel our way in the mist as best we can. There are quite a number of factors about which, for the time being at least, we are uninformed. We do not know whether during the transition period Congress is going to authorize advances by the United States to foreign countries in order to provide the means with which to pay us for their purchases of foodstuffs or other necessities. At present the symptoms point the other way.

If, however, the government itself is not going to finance the sale of these goods, the volume of such foreign purchases is likely to be reduced or at least delayed so as to synchronize with the amounts of dollars that can be raised here by the opening of temporary banking credits, or by the free sale in our market of foreign government bonds or foreign assets. In that case our exports are likely to move at a slower pace and there is less likelihood of a congested demand for goods for export, and therefore, prices are likely more promptly to find their own natural level.

Conversely, should the United States Government decide to advance the amounts involved to the purchasing nations, greater immediate stimulation of certain export industries would follow, coupled with the resulting possibility of continuing for some time at least the exercise of a certain control of prices and distribution, thereby causing a more gradual decline. Of the two courses our first impulse, I believe, would make us choose the latter. Closer study is likely, however, to gain our support for the first of the two methods.

There is much to be said in favor of a quick return to the natural basis. While it must be conceded that unhampered development may temporarily produce a greater shock, we must bear in mind that, on the other hand, trade and industry are unlikely to proceed at full speed until there prevails a general and confident feeling that a natural solid basis has been reached. What would be gained by governmental assistance to our foreign purchases would be lost, therefore, by the creation of a sentiment of reserve and hesitation caused by the hothouse atmosphere.

Moreover, now that the War is won, we cannot blink the fact that impatience is general to shake off restrictions and bothersome regulations, and there is grave doubt as to whether an effective control of output, distribution, and prices could be continued any longer. While the cushioning of the shock might appear very desirable on account of its bearing upon unemployment and wages, the fact must not be overlooked that by the systematic and wise curtailment during the War of expenditures for maintenance and new construction, for necessaries and luxuries, we have now happily stored up a reserve purchasing power which, together with the natural foreign demand, should prove a very efficient shock absorber.

These conditions would not appear to warrant the fear of the imminence of very drastic convulsions in the labor market. But even a temporary jolt should not frighten labor, provided that there results a prompt establishment of a solid basis on which business can develop healthily and freely. Weighing all pros and cons as far as we are able to see them and realizing that requirements may differ in the several branches of industry and trade, it would seem that on the whole the evidence favors an early withdrawal of the hand of government in regulating production and prices.[1]

The policy indicated by the Treasury of prompt liquidation of government contracts, even though compensation for cancellation might involve large sums, appears most advisable in the circumstances. Prompt payment by the Treasury of all such obligations would ease very materially the general situation, it would enable industry to clean the slate rapidly and thoroughly, and get ready for the new business that knocks at our doors.

The above is stated with the greatest possible hesitation by a skipper who knows full well that he is in a fog, but who, having recklessly agreed to discuss this topic to-day, has no choice but to go ahead on the best observations and soundings that he is able to make.

But whether or not our assumptions be correct, in trying to survey the field of our future financing, we may take it for granted that, should our government cease to make advances to our Allies, some of them are most likely to offer for sale in our market their own government bonds or notes, or their industrial properties. I feel certain that vast amounts of the obligations of our strong friends will find a cordial reception here and will be readily absorbed; but taking it all in all it appears extremely doubtful whether our investment houses will find it possible to place foreign securities on a large enough scale to meet the large foreign requirements for our goods.

The task will be made all the more difficult, because as some of these countries have just passed through a period of unrest

[1] I am not including the activities of the War Trade Board, whose control, in certain respects, may have to be continued until the free use of shipping facilities will be restored to our trade.

and great financial strain, we may expect the investor to insist on some evidence that new political conditions have come to stay and that he may rely on an undisturbed economic development before he risks his money.

On the other hand, this period may offer great opportunities for the acquisition of most valuable foreign properties. Some nations, particularly those with strong credit, might possibly prefer sooner or later to dispose of some of their national securities or assets rather than to increase their indebtedness to us by the acceptance of further loans; other countries may have to sell in order to pay their debts because their national credit has been destroyed. From the business point of view it would obviously be to our advantage to buy assets of this sort (or, as the case may be, to make advances secured by such assets with an option to buy them) instead of taking an unsecured long-term foreign government obligation.

It is evident why, in the long run, it is more desirable for the United States to acquire the electric light and power plants, telegraph and telephone lines, railroads, mines, or other industrial plants, than to advance to others the money with which to carry these properties; for whoever owns and controls these foreign plants is most likely to secure for his nationals the orders for raw material and manufactured articles that go with their upkeep and development. Regular orders of this nature have shown themselves to be a most valuable nucleus around which further business crystallizes.

It is estimated that England, France, and Germany before the beginning of the War invested annually an aggregate of over a billion dollars in foreign countries. For more than four years countries like the South and Central American republics and China have not been able to secure foreign funds in substantial amounts, and while the War has taught them the necessity of a greater degree of thrift and more extensive reliance upon their own resources, their accumulated appetite for foreign capital must now be large.

Add to that the demands of European nations, new and old, and it will be clear that by sheer force of circumstances, even though England, France, Holland, Japan, the Scandinavian countries, and others will take their full share of the burden, we shall soon be driven into a position of great importance in international finance, and that this responsibility will be facing us long before we may expect to see our market for foreign securities develop far enough adequately to meet the situation.

I believe that so-called "investment trusts" will ultimately play an important rôle in solving this problem. Companies of that character are well known in England, particularly in Scotland. As their name indicates, they invest their funds in foreign securities, and against their assets they issue their stocks and bonds for sale in the home market. One important corporation of this description has been launched in the United States, the American International Corporation. More such companies, I think, are bound to be created. But it will take years to establish their prestige and standing all over the country and to prepare for their securities an investment field wide enough to fill our needs.

In these circumstances, it occured to me sometime ago that by converting the War Finance Corporation into a Peace Finance Corporation and authorizing it to acquire directly, or make advances on foreign securities, we might create an instrument that would promote our foreign trade and at the same time greatly assist foreign nations in need of our support during a period of political and economic transition. Such a Peace Finance Corporation, enjoying the prestige and strength flowing from the $500,000,000 capital subscribed by the United States, could exercise effectively its power, within certain limits and for a limited number of years, to issue its own obligations against the foreign securities acquired.[1] In

[1] These obligations should not be eligible as collateral for notes rediscountable with Federal reserve banks. They should be placed only as fast as they can be absorbed by the investors.

doing so it might render services of the very greatest value in bridging a critical interval. At the same time, it would keep the government out of direct touch with business transactions, with which, for a thousand obvious reasons, it had better remain unconnected.

For the sake of both our domestic and our foreign problems, I believe a plan of this kind is deserving of our most careful consideration, even though I am reluctant to suggest it because of my strong belief that at this time we should remove rather than construct war emergency machinery that draws the government into business and on account of other serious and valid objections which at once occur to us.

The greatest difficulty, and one that cannot be weighed too conscientiously, is that of devising a plan which will provide a sufficient assurance that we may rely on securing men able, expert, and independent enough to be entrusted with the administration of funds amounting to possibly billions of dollars, men who would have to be vested with wide powers in dealing with what, in effect, would amount to the people's money.

In order to win the War and while it lasted, we were willing to concentrate such powers in the hands of a few. Would Congress be prepared to go that far for purposes of reconstruction? That is doubtful, and personally I believe that, in spite of its obvious necessities and advantages, the step, involving as it does transactions with foreign countries, could safely be undertaken only if we could remove every reasonable doubt with respect to our ability to secure the proper men and to keep the Corporation's management so separate and distinct from the direct responsibility of the government as to protect both the government and the Corporation from any embarrassment likely to result in dealing with foreign nations.

A solution might be found by providing that the Peace Finance Corporation should be administered by a board of directors, of whom one each, with the approval of the President, would be designated by the Secretary of State, the Secretary of the Treasury, the Secretary of Commerce, the Federal Reserve Board, the War Industries Board, the War Trade Board, the Shipping Board, and the Food Administration (each selecting at the same time a substitute director for their appointee). These directors then would elect the general manager and other officers.

A method of this kind would be likely to secure a non-partisan expert administration, a majority of whom would be non-partisan expert men of national reputation and of widely divergent interests. I think a board of that kind might safely be entrusted with the necessary wide powers; it would embody all the elements that are at present charged with the duty of regulating commerce and finance, particularly in their relation to foreign countries. In case of vacancies occuring after one or more of the appointing boards had ceased to exist, other boards such as the Federal Trade Commission and the Tariff Board might take their place, or the board of the Peace Finance Corporation itself might be empowered to submit to the President names of candidates. There may be many better ways of appointing the board; the above method is suggested simply for the purpose of illustration.

In many foreign countries there are men now on the ground, serving as emissaries of the Department of Commerce, or as representatives of the Treasury, or acting in connection with the business operations of the Army and Navy or the American relief organizations. Would it not be possible to constitute from men thus available abroad and the best men qualified in the United States, advisory commissions to cover each country, not only in Europe, but also in South America and Asia? These men might render invaluable service to a Peace Finance Corporation, and ultimately they would become important factors in creating in the United States the atmosphere of knowledge and understanding of foreign conditions so important for the development of our future trade and finance. At the same time it will be very desirable to have available in some of these countries groups of men who will keep an eye on the proper distribution of goods furnished by us.

Whatever form of financing, however, the reconstruction period may bring, whether securities issued by our own government, or by a Peace Finance Corporation, or by foreign governments or foreign corporations, it is certain that their successful absorption will depend upon the saving capacity of our people.

I believe we cannot emphasize too strongly that the time has not yet come when our people, large or small, may relax their efforts to curtail unnecessary consumption, both for the sake of releasing for export the greatest possible quantities of goods, thereby stimulating our export industries, and for the purpose of accumulating funds available for investment. The slogan "don't stop saving food" would gain in scope and strength by abbreviating it into "don't stop saving!" Our millions of Liberty bond holders must be trained to become permanent investors; thrift must become a national virtue, a priceless inheritance left to us by the War. The splendid saving mechanisms now in use should be continued and expanded, they should not be permitted to die when government borrowing ceases.

It is most important that our coming Victory Loan be absorbed as far as possible not by bank borrowings, but by genuine savings. Thanks to the strength provided by the Federal Reserve System, our banks have been able to meet the strain of the War in a most admirable way, and, as in every previous loan, they will be found prepared for whatever burden the next loan may bring.

But do not let us be unmindful of the fact that since our entry into the War the reserves of the Federal reserve banks have fallen from 85 to about 50 per cent, that the aggregate investments of Federal reserve banks have increased in that period from $225,000,000 to over $2,300,000,000, and that the proportion of national banks' investments to deposits at present amounts to 130 per cent against 110 per cent at the beginning of the War in 1914.

We are near the crest of the wave of world-wide inflation. As it was generated and fostered by a chain of interlocking effects and reactions of extraordinary demands for certain goods, reduced power of production of others, rising prices, rising wages, vast issues of government bonds and circulating notes, so with the approaching end of the issues of government loans we may expect to see the beginning of a gradual contraction of note issues and deflation of prices and wages [1] and a return to more normal conditions of production and consumption.

As far as the banking situation is concerned, deflation will have to be brought about primarily by the people's efforts to save and by a contraction of loans following the shrinkage of prices of goods and reduction of the volume of inventories.

On November 8th the 751 member banks in leading cities submitting weekly reports to the Federal Reserve Board held $1,200,000,000 of loans secured by government war obligations in addition to $1,806,000,000 of government securities (exclusive of $268,000,000 deposited for the issue of national bank currency), making the total holdings by these reporting member banks of government war obligations and paper secured by such obligations in excess of three billion dollars, of which a substantial proportion was pledged as security for loans obtained from Federal reserve banks. On the same date the amount of this class of paper which the Federal reserve banks had discounted for their members aggregated $1,317,000,000.

The government bonds held by the banks ought to be absorbed by the public as fast as possible and the extended

[1] Wages control prices and prices control wages; they have to move together. I cannot but believe that Mr. Gompers had in mind in his recent speech the preservation of the relative position of wages, that is, their purchasing power (based upon index numbers or what is spoken of as real wages, as distinct from nominal wages). Any other thought is an impossibility.

position of both member banks and the Federal reserve banks correspondingly eased. Depositors by turning into investors would reduce our deposit structure, which from the beginning of the War in 1914 has risen from $21,330,000,000 to about $32,000,000,000, and thereby decrease the banks' reserve requirements. This in turn would have the effect of reducing the rediscounts made by member banks in order to provide the necessary reserve balances with Federal reserve banks.

While it is possible that the aggregate of investments of the Federal reserve banks will still rise in consequence of the payment of the installments due on the Fourth Liberty Loan and the Victory Loan to be expected in the spring, we must hope that the peak will be reached in the near future and that from then on we may witness a continuous and substantial decline in bank investments and a corresponding rise in the percentage of reserves.

Nothing could be more beneficial to the prestige of the United States as a world power in finance than the early and courageous lifting of the gold embargo. It is true that before contemplating this step, it will probably be necessary to have an ample tonnage at our free disposal for the unhampered transportation of our goods (and other conditions will have to be considered which it would lead too far to discuss here), but it is also true that the stronger our gold reserve at that time, the more readily will we be able to envisage with complacency the probability of the consequent exportation of sums of gold which, conceivably, may amount to hundreds of millions of dollars.

It is for this very important reason that it is sincerely to be hoped that the people by saving and curtailing of unnecessary consumption and expenditures, and the business community by a program of wise moderation, particularly dealing with non-essentials, and as long as this can be done without creating unemployment, will do their share in consolidating both our gold and investment strength, on which two factors, our ability to secure our proper position in foreign lands, and our power to act boldly and generously in dealing with other nations, are largely predicated.

Over-expansion of deposits and note issues must not be permitted to tie up our reserves to such a degree as to interfere with our power to let gold go out freely. While we are still in a position of great strength, we must remain conscious of the necessity of not forgetting our limitations.

If by the exportation of large amounts of gold or a continual increase of investments our Federal Reserve System's cash reserves were to fall from fifty to about forty per cent, that by comparison with other countries would still look like a very high reserve. Do not let us forget, however, that in Europe reserves before the War were considered to be near a normal level at approximately sixty per cent, and that this was at a time when central bank countries were saturated with gold, owing to the hundreds of millions in actual gold carried in the pockets of the people, while now this important secondary reserve has been wiped out in almost all leading countries.

They have wisely concentrated that gold in the central banks in order to have it serve as a basis for their vastly increased note and deposit obligations. Logically, future central banks' reserve standards ought, therefore, be higher than those of the past.

While we must resign ourselves to the conclusion that it will be a "long, long way" to the realization of any such hope, it is all the more evident how important it is for all countries firmly to envisage this goal of strengthening their present financial position by a gradual deflation, and continued efforts to concentrate all scattered gold.

The world balance sheet has been "watered" by issuing war loans and currency against things already consumed or of no permanent value, to an aggregate amount appraised to exceed the estimated pre-war wealth of England and Germany combined. The squeezing out of this water by gradual amortization of war loans and contraction of note issues will prove an important factor in reëstablishing pre-war levels of prices.

Some writers hold to the view that increased production of goods rather than banking deflation may bring us back to a normal relation between money and goods. My own belief is that the solution must be sought in efforts from both ends. The resultant line indicating the trend of prices and deflation would then lie somewhere around midway between the highest and lowest points.

Perhaps I should say a word at this juncture concerning the much mooted question of the demonetization of gold as a world medium of exchange. In considering the suggestions made in this connection I have to think of the deaf old lady who, when asked by her table neighbor whether she liked red bananas, answered: "No, my dear, I prefer the old-fashioned night shirt." I confess, when dealing with this problem, that I, too, am old-fashioned. I believe that gold as a medium of actual circulation within the border lines of countries will more and more be relegated to the past; but that as a basis for an elastic circulation and as the ultimate means of settlement of international balances, it will continue to dominate the world. It will not be dethroned for the reason, if for no other, that such a step could only be taken by mutual agreement between gold debtor and gold creditor.

The position of economic superiority held by a creditor country owning a large stock of gold is, however, of so immense an advantage that it will not be voluntarily relinquished by the large number of nations that are the *beati possidentes*.

Nor do I believe that the world has turned far enough into a family of communists seriously to consider the pooling by all countries of their holdings of gold. As long as nations have separate national budgets and obligations, they are likely to wish to retain a distinct ownership of their assets. The problems of reconstruction are immense and immediate; the new structure must be erected on the most solid foundation and built with material that is thoroughly tested and promptly and actually available.

Nor can we deal effectively with the foreign exchange question without first freeing our minds from doubtful theories. We must cling to the old dogma that foreign exchange will continue to be the result of the foreign trade and credit of each individual nation, the balance, as far as not squared by the flow of goods, loans and securities (including bills of exchange) or bank balances remaining to be settled in gold. The War, drastically obstructing all these natural currents, brought violent and most regrettable disturbances to the foreign exchange markets. But we have seen that the very approach of the Armistice, promising the return of normal trade conditions, turned back our exchange rates towards their fairly normal level.

I do not believe, therefore, that there is any necessity for the establishment by the government of a foreign exchange bank, which has been urged as a reconstruction measure, for the purpose of keeping dollar exchange at par, or our discount rate for bankers' acceptances at 3½ per cent, or for providing the country with adequate foreign exchange and credit facilities at fair and equitable rates. If it is shown that American banks and bankers are so lacking in spirit of enterprise that our business men, at fair rates of compensation, cannot secure adequate facilities for the carrying on of their foreign transactions, then such a bank should be organized.

In that case, however, it should not be a note-issuing bank, but a plain and unhampered business organization under government control. So far nothing has changed my knowledge and conviction that the foreign exchange business in times of peace is being transacted on the most modest margin of profit; that our American banks, since the shackles were taken off them four years ago,[1] have moved rapidly into foreign

[1] It was only two years ago that the power was granted to national banks to combine in holding stock in banks organized to do foreign business. The

fields, and that they may be relied upon to do their share in the future.

Attention has been drawn to the preliminary steps taken by many European nations for the organization of banks designed to protect the foreign exchanges of their respective countries. But the conditions of these nations are not ours. Countries that are dependent upon the importation of goods and at the same time have to find means of annually remitting abroad large sums in payment of interest and amortization have a very real and serious problem on their hands, one from which, happily, we have reason to hope to be immune, at least for some years to come.

With the vast credit balance annually accumulating in our favor, adverse exchange conditions, barring unforeseen emergencies, can normally be brought about only by excessive foreign investments, and these can be adjusted by a modification of our financial policy at home, but not by the operation of a foreign exchange bank. Nor would it have been within the power of such a foreign exchange bank to stabilize our dollar exchange during the War.

It is now well understood that apart from the interruption of our trade with neutrals, the prevailing and regrettable disturbance in our neutral exchanges was largely a question of the use of the proceeds of our loans granted to our Allies, and of other "*force majeure*" influences which it would lead too far to enter into, but which would have been beyond the power of such a bank to regulate. As stated before, when the seas are open to our unhampered trade, when our foreign loans are under proper control, with our huge gold stock and an effective discount market, our foreign exchange situation can be protected without the creation of a new government bank.

Nor is such a bank necessary in order to put our discount rates on an equal level with those of London. It cannot be

national charter for such foreign banks has not yet been granted, in spite of the urgent and persistent representations of the Federal Reserve Board.

denied that it is an anomaly, which rankles in the minds of some of our critics, that our acceptance discount rate should at present be at 4¼ per cent, while the British rate is at 3½ per cent at a time when England is borrowing from us at a rate well in excess of 4¼ per cent.

As long, however, as the United States Treasury has to raise about one and a half billions per month by the sale of Treasury certificates at 4½ per cent, it is evident that a reduction by the Federal reserve banks of their discount rate to 3½ per cent would only have the effect of inducing the banks and trust companies to sell all their acceptances to the Federal reserve banks at that rate, in order to buy Treasury certificates at 4½ per cent, or commercial paper at 6 per cent.

In other words, it would tend to encourage expansion and at the same time destroy the broad market for acceptances which as a result of the labor of several years has been developed, with a constantly growing number of banks purchasing these acceptances. The low rate, if adopted, would be likely to make the Federal reserve banks the only market. If, on the other hand, the Treasury reduced its rate on certificates to 3½ per cent it would court certain failure in its attempt to raise the vast amounts required each month.

As against these conditions, it may be taken as a fact that the low acceptance rate established in England proved of a very real value to our Ally on account of its bearing upon the British government's gigantic and highly successful loan operations in the home market. Must we not ask ourselves whether that was not a sufficient compensation for the temporary disadvantage at which we were placed? Was not the common object to be gained more important than the question of the relative position of vantage between Allies?

As stated before, we may expect that anomalies of this kind will cease as soon as treasuries discontinue to issue government loans and when the natural flow of money again dictates the rate policy of the countries under the leadership of their central banks. It cannot take long for a natural adjustment to take place on these lines and we can well afford to be patient in the interval, whether it extends over half a year or even a little longer, during this transition period of reconstruction.

Was it not the redeeming feature of the horrors through which we were passing that for a common aim men were willing to share with one another suffering, privation, and death? And is it not one of the most inspiring features of reconstruction that a spirit of competition in giving and sharing with one another has come to us to take the place of the one-time spirit of keen competition for possession and position?

In thinking of financial reconstruction and of the financial world of the future, do not too many among us have this one thought uppermost in mind: Is the United States hereafter going to be the leading financial country? In other words, are we going to take England's place as the foremost financial power? Do not these men forget that if England were to surrender her entire trade and banking to us, we should collapse, and that if we were to unload all our business on her, she would break down under the burden?

The whole truth of the matter is, that we have both grown to be pillars supporting the same structure and that neither can fall or become weakened without bringing danger or disaster on the other. England, herself the owner of billions of foreign obligations, will remain the banking center of Europe, a world clearing house for goods and credits. I believe that her banks and ours will be found in close coöperation, sharing the burdens in bond issues and credits, and relieving each other as the tide may swing from time to time.

Personally, I think it is finer and healthier for us not to think so much of the rank as of the responsibility of our position. Among nations, as among men, it is not prudent to place oneself on a pedestal overtowering the rest. Whoever rises too far above his neighbors ultimately makes himself their target.

Moreover, conditions of too glaring advantage do not remain long without the disproportion being adjusted in one way or another. An overabundance of capital and material on our part will soon draw towards our shores as an equalizing force a stream of men anxious to divide with us our position of advantage, and surplus capital flowing into poorer countries will help them to develop their own resources. The ultimate course of the process of adjustment will largely be influenced by the attitude and power of labor and our future tariff policy.

If I read aright the signs of the times, England and the United States, soon to be joined by France, Allies of the past, will be partners rather than competitors in the future—partners not of a close corporation to the exclusion of others, it will be a partnership wide open for any respectable new associate wishing to enter. Or perhaps we might more properly term them joint trustees, with others, administering a great public trust. If there is to be immediate and intense competition between their peoples, it ought to be on this one and only ground, "who will be able to save most in order to be able to help most."

The ownership of no less than $8,000,000,000 of foreign government obligations (probably billions more before we are quite through) conveys to the government of the United States the possession of a master key controlling the foreign exchange market for some years to come.

Nobody is wise enough to say to-day what the ultimate disposition of these foreign bond holdings will be. Some bonds may be actually paid off when due, others may have to be renewed by our government, in other cases foreign governments, when their bonds mature, as a renewal operation may offer their own bonds for sale to the American investor (instead of to our government).

We may assume, however, with entire confidence, that the United States is not going to be a hard and exacting creditor. While our government may find that, as a matter of protection against unexpected economic or political developments, it may be advisable to keep a certain portion of our foreign loans in bonds of a reasonably short maturity, renewable from time to time, there cannot be any doubt that the decisions of any future administration concerning the ultimate liquidation or continuation of these debts will not be reached from mercenary or selfish motives, but that they will spring from considerations of the larger duties towards the world as a whole, and from minds fresh with the memories of the sacred purposes for which these obligations were incurred.

It would unduly tax your patience to give a complete list of the things in which I do not believe, but it may not be inopportune for me to digress here for a moment in order to express the hope that Congress may see its way clear to exempt from taxation the interest received by foreigners on bank deposits in the United States, or on their investments in loans, discounts, or American bills of exchange. Other countries e. g., England, have imposed taxes on income received by foreigners from permanent investments; but England has never undertaken to tax foreigners on revenues from sources of income which do not constitute permanent investment. England, not only commercially but also financially, is a free-trade country, and it is largely to her liberal attitude in this respect that she owes her position as the world's banker.

Petty and vexatious taxation of revenues from bank balances and bills of exchange will result in placing a severe handicap upon American banks in their efforts to give to American paper and American balances the same standing as that enjoyed by their British brethren. Such taxation not only impedes the free flow of money, but in the final analysis hurts the American borrower, who will be the one to "pay the piper" by being compelled to stand the higher interest charges which would result. I should earnestly urge, therefore, that Congress examine this question very seriously when framing the revenue bill now under consideration.

Just as I was finishing the writing of this address there came to my knowledge an abstract of the report of the British committee appointed to investigate the question of currency and foreign exchange after the War, of which Lord Cunliffe, the esteemed ex-Governor of the Bank of England, is the chairman. It was extremely gratifying to find that the conclusions reached by this committee bear out entirely the thoughts that I have ventured to express in this paper with regard to Treasury borrowings, discount rates—and deflation.

The report urges as prerequisites for the restoration of an effective gold standard, "which should be restored without delay:"

The cessation of government borrowing as soon as possible after the War, and the provision at the earliest possible moment of an adequate sinking fund for the purpose of bringing about a regular annual reduction of capital liabilities;

A cautious reduction of the outstanding uncovered note issue and a greater concentration and strengthening of the gold reserve;

And, furthermore, the bringing into effect of the "machinery, which long experience has shown to be the only effective remedy for an adverse balance of trade and an undue growth of credit." This machinery is defined as "the raising and making effective of the Bank of England's discount rate, which before the War operated to check a foreign drain of gold and the speculative expansion of credit." "This necessity," the report says, "cannot, and should not, be evaded by any attempt to continue differential rates for home and foreign money after the War."[1]

[1] The report is significant, furthermore, in its unqualified recommendation that "the gold reserves of the country should be held by one central institution and that all banks should transfer any gold now held by them to the Bank of England." That is exactly the policy the Federal Reserve Board persistently urged upon Congress, a policy fortunately adopted and since enacted into law. Without such amendment it would have been impossible

Lord Cunliffe's sound advice to let business return as soon as possible into its old and tried channels will no doubt be heartily acclaimed by our business men and bankers.

Under the able leadership of the Secretary of the Treasury—in whose retirement we regretfully lose a courageous and efficient general, deserving of the country's deep gratitude, our task of war financing has been most brilliantly performed. The Federal Reserve System, now unfolded to a position of power and influence far beyond the early expectations of its very proponents, and the banks of the country, placed through it upon a new basis of safety and of wider scope of operation, will show themselves physically and intellectually equipped for their larger tasks whenever the moment comes for the Treasury safely and properly to return to a peace footing in the exercise of its own functions.

May I avail myself of this opportunity to state that I believe the country is to be sincerely congratulated upon Hon. Carter Glass's appointment as our next Secretary of the Treasury. Nobody has done more in formulating and passing the Federal Reserve Act than he. Nobody has rendered greater services than he in keeping out of harm's way the schemers and dreamers that might have endangered or wrecked our banking structure.

The country is deeply indebted to him to-day, and I am certain that as Secretary of the Treasury he will add further distinction to his record of public service. Through five years of intimate association, I have grown to know and sincerely admire this unassuming and unselfish man as one of our finest citizens and as a fearless fighter sacrificing himself without stint or reserve for whatever he deemed to be best for the country. I consider it a privilege to be permitted to pay him this tribute.

for the Federal Reserve System to accumulate the more than $2,000,000,000 of gold which enabled it successfully to stand the unprecedented strain of financing the War.

As military victory could not be won without the loss of lives, so financial victory could not be secured without economic sacrifices, not only of a material character, but also of principles which normally we hold dear. Inflation of prices and temporary surrender of individual freedom of operation are cases in point. Success having been achieved, we now are starting to wend our way back. We have fairly well reached the top of the mountain, we do not exactly know whether it is a peak or a high plateau. The transition period will keep us moving over it, and then gradually, as we ascended we shall have to descend through the period of reconstruction, until we reach the normal level of the future.

Happily, in the case of finance, the course of our path lies fairly clearly ahead of us, because the relations between government and business had been defined by the Federal Reserve Act on a modern and satisfactory basis before the War broke out. In banking, the formula for private operation under government control had been found and put into effect. Conditions are not so clear with respect to other and similar problems, such as the railroads, the financing of which forms a part of our program, which it would lead too far here to discuss. This only we might say in conclusion:

The War has accentuated and vastly accelerated the growth of government responsibility and influence in business. This development is worldwide at this time, it is natural, logical, and inevitable. While it will tend to elevate business, there is danger that unless carefully safeguarded in both form and scope, it may tend to corrupt and to debauch government. It is this peril that we are facing at the moment of our proudest triumph, and it must be our serious concern that a national effort born in idealism should not bear the seeds of ultimate national decline. The reconstruction period places us face to face with this problem and it is during this period that thoughts will have to be developed leading to a solution entirely fair to the people.

In the case of the railroads, it is not solely a question between security holders and shippers; it is a question which affects on the one hand the integrity and safety of our future political life, and on the other the very foundation of our economic development. The next year or two must bring forth legislation which ought to be for the railroads what the Federal Reserve Act has been for the banks. To find the proper formula will be a national contribution of the highest order. It will be a difficult task, but just for that reason one worthy of the efforts of the best minds of the country. It is not solely a question of railroad technique or finance. A larger problem is involved; one that will face us at every future step in the evolution of the relation between government and private enterprise; the problem of finding men big, trustworthy, expert, and independent enough to measure up to the task, and to make the task independent, clean, non-partisan, and dignified enough to measure up to the men.

Until that phase of the problem is solved, government regulation or operation in times of peace will remain imperfect and fraught with dangers threatening to outweigh its benefits. No time ever was more propitious than the present for making a determined start in this direction.

The reconstruction period is pregnant with the seeds of good or evil; what it brings forth will depend upon the care and devotion that the country gives to its problems. It is a period, as its name indicates, for constructive thought, not for destructive criticism. If the flower of our manhood is willing to serve the country during reconstruction and peace as it did in times of war, and if the country's new and larger duties, and its higher conceptions of them have taught it to want as its servants none but the truly best, then we may look into the future with hope and confidence that we may prove ourselves competent and faithful guardians of the sacred trust which this glorious period has placed in our hands.

JANUARY 21, 1919

XXV

THE ORGANIZATION OF THE AMERICAN ACCEPTANCE COUNCIL

Remarks Made at a Conference of Business Men and Bankers Held in the Assembly Room of the Merchants' Association of New York

I BELIEVE the enlargement of the scope of the activities of your Council as indicated by the change of name from "Trade Acceptance Council" to the "American Acceptance Council" is a wise one. As the economic development of the country brings about a more intense interest in foreign trade, it is timely that this Council should center its attention not only on the "trade acceptance," which is mainly a domestic affair, but also on the "bankers' acceptance," an instrument primarily financing international trade. I have no doubt, and sincerely hope, that in enlarging its field of activities it cannot be the intention of the Acceptance Council to lessen its efforts to carry on an effective campaign in preaching the gospel of the use of the trade acceptance. I have not changed my conviction that the trade acceptance is going to play a most important part in our commercial and financial structure, and that the country's interests are well served by the Council continuing an active propaganda for its use wherever it can be adopted to advantage.

On the other hand, in embarking upon a campaign of study and instruction with regard to the widest and most profitable use of the "bankers' acceptance," I believe the Council will find an opportunity for a great service in many directions. It can give valuable information to the business men with respect to the use not only of the trade acceptance, but also of the "bankers' acceptance," both in domestic and foreign trade. In addition, it can enlist the interest of many banks and trust companies and private firms that heretofore have not taken up the acceptance business.

While, generally speaking, it is readily conceded that it is the duty of the United States to use its newly acquired gigantic financial strength in granting credits to other countries, it is little realized that this aim and duty of ours cannot be accomplished by any small group of banks or men, but that in order to bring our plans to the fullest possible realization, everybody has to do his share. The War has taught us the value of cumulative effort in warfare as well as in saving. This cumulative effort is necessary also in banking if the United States is to become a leading financial center of equal importance with the strongest of Europe. In saying this I do not mean to indicate that I wish to see small and unimportant banks entering the acceptance field; quite the contrary, it is important that the class of acceptances which will be offered in the American discount market should be uniformly of the highest possible standard. While for the domestic business local acceptances of smaller institutions will do, provided they are of undoubted character, international acceptances only of large and well known banks and firms will find a free and regular market.

It is important, therefore, that the strong banks and firms enjoying a high standing should do their share in this national work and take an interest in the development of the acceptance business. Where such firms do not exist, or where, for reasons of their own, they rather prefer not to "accept," it is to be hoped that strong acceptance corporations will be launched in growing numbers, which will specialize in doing an acceptance business. These corporations, under the rulings of the Board, may accept their capital and surplus many times over, their own resources being invested in such a manner as to act as a liquid and readily available reserve, or insurance fund, for the protection of the acceptance liabilities of the corporation.

I believe that in developing the acceptance business in the United States it is most important that we should proceed cautiously and avoid as much as possible any untoward event which might undermine the absolute confidence in our bankers' acceptances as an investment both here and abroad. In other words, we must do everything to avoid failures which might result from over-expansion, over-aggressiveness, and recklessness in granting credits. I do not believe that it is advisable to go too fast in increasing the legal limits up to which member banks or acceptance corporations may accept. If these limits are to be increased, they ought to be very carefully safeguarded. I do not feel happy in throwing out this suggestion, because my own preference is for the British system, which permits the acceptance business to develop without any legal limitations, leaving the limitations to be established to the business sagacity of those that accept and of those that buy the acceptances. We must not overlook, however, that England is a country with a comparatively small number of branch-bank institutions and, at this time, of great banking amalgamations, while in the United States we deal with a system of about 30,000 banks, all of which, large or small, would be affected by whatever rule might be established, and one or two among these 30,000 exceeding their limit of prudence may hurt the entire development of our acceptance market.

Generally speaking, I should venture to give it as my opinion that where in the nature of things the capital and surplus of deposit banks form only a comparatively small item as compared with the huge structure of deposits and other liabilities, it would not be advisable to add to that a liability for acceptance credits largely in excess of the capital and surplus. I do not think that European banking experience would show that the various large and strong deposit banks in England and on the Continent accept to any extent materially exceeding their capital and surplus—indeed, in most cases, you will find that they accept to the extent of only a smaller amount. It is different, as already stated, with corporations that organize for the special purpose of doing an acceptance business. Their liabilities, other than acceptances, are practically nil, and there is no reason why, under proper safeguards, they should not extend their acceptance liabilities to substantially the same proportion as is represented by the deposit liabilities, plus 100 per cent acceptance powers of conservative and well managed deposit banks.

I believe that the problem which I have just discussed will offer a very interesting topic for the deliberations of the future American Acceptance Council.

There is nobody that is more ambitious than I in wishing the United States to become a leader in the acceptance business, but I believe the basis for it must be furnished by a proportionate increase in capital and surplus, or by organizing a growing number of acceptance corporations, or by interesting a growing number of private banking firms, but not by unreasonably over-extending the individual acceptance obligations. I believe that the future of the American acceptance is an extremely bright one, because the relative attractiveness of international acceptance rates is largely governed by the gold power of the few countries involved in that business.

It is impossible to foretell at this moment what our position will be at the conclusion of peace, and how far arrangements to be made between the Allies, and possibly with other countries, will affect our present position of great gold strength. As conditions appear to-day, it would seem that the easiest and most natural way for us to share this strength with others would be by taking upon our shoulders a large share of the credit business, and particularly in the granting of banking credits to be furnished by the world's banking centers.

There is another important field of activity which I believe will prove interesting and profitable to the future American Acceptance Council, that is to impress upon all the banks of the United States the growing importance of investing a substantial portion of their deposits in American bankers' acceptances. It stands to reason that within a year the amount of United States Treasury bills held by all the banks of the country will become very substantially reduced. Indeed, we hope that after a reasonable time the United States as a borrower on short-term paper will practically disappear from the market. The banks of the country have now been trained to keep a large portion of their liquid assets invested in Treasury certificates, and to use them and the war paper of their customers when borrowing from the Federal reserve banks at preferential rates. The preferential rate in the future will be that for "bankers' acceptances," and the vast place now occupied by Treasury certificates and war paper is likely to be taken up to a large extent by "bankers' acceptances."[1] Such a development would, in itself, create a standing demand for acceptances and would make for a low rate for them.

May I ask you to bear in mind also that when, by a process of gradual absorption, the Liberty Loan bonds will have percolated into the hands of investors, and bank loans will have been freed to that extent, it will not be possible for Federal reserve banks to liquidate entirely the vast increase in investments brought about during the War. We all hope and expect that the amounts of these investments, now about two billions, will gradually be substantially reduced, but I do not believe that it will be possible for all the banks of the country to pay off their loans with their respective Federal reserve banks sufficiently to bring the investments of the Federal Reserve System back to a pre-war volume. When we return to normal conditions, it is likely that the Federal Reserve System will be found carrying as a permanent investment a sum very largely in excess of its pre-war normal load, and it is to be expected that then, with war paper gone out of existence, acceptances will again play the leading rôle in the investments of the Federal Reserve System.

This is taking a long view of things and engaging in the somewhat risky business of acting as a prophet, but I feel confident enough to suggest at least the possibility of such a development.

There is a very interesting opportunity for local discount companies to play a useful part in this development, but it would lead too far to go into this question here, and I mention it only as one of the topics that the Acceptance Council may discuss to advantage.

And finally, the Council, I believe, will be able to render an important service in making itself a clearing house for helpful thoughts and suggestions that might be useful in developing bankers' and trade acceptances in the United States, and in assimilating these thoughts for the benefit not only of the banking community, but of the Federal Reserve Board and of Congress. My life in Washington has taught me that it is one of the most difficult problems for men, devoting themselves to the government service and living in "splendid isolation" in Washington, to remain in touch with the practical business thought and the actual requirements of the hour. On the other hand, it has shown me how difficult it is for the average banker and business man to take anything but the local and self-centered point of view. The Acceptance Council, remaining in active touch with those whose duty it is to consider the questions in their wider bearings, can exercise a most important function in carrying the local business knowledge to the seat of government, while it can take back to the banking and business community the national point of view, considering the interests of the country as a whole.

APRIL 2, 1919

XXVI

INVESTMENT OF AMERICAN CAPITAL ABROAD

Remarks Made at the Dinner of the Council on Foreign Relations

SAGACIOUS direction of the flow of American capital into foreign lands and of the influx of foreign securities into the United States is one of the most important and at the same time most puzzling features of our present banking problem. It is not merely a question of finance, but it is closely interwoven with the future development of our domestic and foreign trade and the trend of immigration, wages, and prices.

We are all familiar with the underlying conditions that render so immediate and so burning this question of "Investment of American Capital Abroad." It is unnecessary, therefore, to review in detail the changes in our economic position resulting from the World War. We, around this table, appreciate fully the duties that now are ours in consequence of the attainment of a position of such overtowering economic strength as to place other nations—with whom, both for their sake and ours, we must continue to trade—in a position of having to make good to us an annual debit trade balance larger than they may be able to settle by the shipment of goods or gold. In these circumstances, it is inevitable that such foreign customers must either sell us other foreign securities or assets they now hold, or their own national obligations, or failing that, they must make money so attractive within their own boundaries that our capital will seek investment there. To the extent that, during the next years, at least, these processes will be facilitated, our foreign trade will grow, and inversely, to the extent that this flow of capital and securities is impeded, our foreign trade will be discouraged.

It is impossible to weigh at this time the relative importance of the services our capital may render at home or abroad. Moreover, even were we inclined to consider the problem from a purely selfish point of view, it is obvious that we are not dealing with a moot question, but with an actual condition. The balance in our favor exists to-day and it will remain to be squared every year, unless, indeed, we contemplate that the peace settlement will provide for a cancellation of the approximately ten billion dollars advanced by us to nations associated with us in the common struggle. Personally, I do not believe that a cancellation of this sort will be proposed, but I believe we should be prepared for some years to come to facilitate the remittance to us of the approximately $500,000,000 which annually will be due the United States on account of interest on its foreign loans.

Relief of this kind could be brought about by a scheme somewhat on the lines of "funding operations." That is to say, the debtors should be permitted to pay the creditor not in cash, but by the sale of additional long-term bonds. This would give our friends abroad a most valuable "breathing spell" within which to adjust themselves to the new conditions. What form exactly such operations might take is impossible for us to predict. It is conceivable that Congress might authorize the Treasury to accept such foreign government bonds in lieu of cash, the United States in turn raising the corresponding amounts for the payment of its coupons either by borrowing in the market, or by taxation, or by offering these foreign bonds to the American people. If Congress should be unwilling, or where our foreign debtors prefer to do so, they might raise the necessary funds as far as feasible by the direct sale in the American market of their government securities, the proceeds being used to provide the amounts due for the payment of the coupons.

I believe I am safe in saying that in planning for the future, the country will favor a policy of using, wherever practicable, the natural channels of individual effort rather than action by the government. Wherever the government enters business or finance, the natural basis of cost of production is quickly neglected, and resulting deficiencies are made good by taxation. Taxation, on the other hand, has reached such unprecedented scope and, if perpetuated in its present extreme form, may have so disastrous an effect upon the future development of our country, that no step would seem advisable which would unnecessarily push us further in that direction. It would, therefore, be preferable, as far as possible, to work for a direct absorption of these foreign loans by the people instead of having them rest in the possession of our government.

We must bear in mind, however, that the absorption of these annual remittances of approximately $500,000,000 forms only a minor part of the problem. Foreign countries, in addition, will require many billions worth of raw material and finished articles, for which, in their present disorganized condition, they will not be able to pay by the sale of goods or services. Conditions abroad, in some countries, are so grave and alarming that we must frankly admit our inability, or even unwillingness, at this time to come to their support. There are others where we should feel justified and glad to help if only we could see our way clear eventually to open to them the avenues leading to American savings. In such cases the question would arise, could the American investor be made to comprehend the foreign situation? Could we awaken in him a sufficient understanding and confidence to make an appeal to him likely to meet with reasonable success? A three-fold difficulty awaits us in this respect: First, that in the United States the habit of saving and investing has not been sufficiently developed before the War. While great headway has been made during the last two years, it would be unreasonable to assume that the doctrine of thrift has entered deeply enough into the minds of our people to establish a permanent habit.

Second, taxation at this time is in effect confiscating the large annual accumulations of the wealthy classes that heretofore formed the bulk of the capital available for investments. A continuation of such policy of taxation would mean that the successful placing of securities in the future will have to depend largely upon far-reaching distribution among those who will reap the benefit of increased income without being subjected in the same degree to the burden of increased taxation, that is primarily among the wage earners. These in turn will be able to perform this most important function of becoming the country's main investors only if they are taught to use higher wages, not for the purpose of indulging in greater luxuries, euphoniously called the "higher standard of living," but for the purpose of effecting greater savings.

And finally, to carry on successfully this thrift campaign, or as it has recently been aptly termed "sensible spending," is, in itself, a task of very great difficulty. To steer the wage earner's savings directly into foreign investments—barring the securities of undoubted character of a few strong and familiar nations—would, however, be an undertaking beyond our power, and moreover, one of most doubtful wisdom. The wage earner, in making his investments, has no time nor ability for study and discrimination. Grave danger exists, therefore, that advantage might be taken of this circumstance, and that crooked promoters and the like might rob him of his savings.

The small investor needs protection,—that is why in the past he resorted to the instrumentalities of the savings banks or the life insurance companies, who took it upon themselves to scrutinize and pick and choose on his behalf the investments to which his savings should be applied, and to give him an interest in a largely diversified investment where the risk had been spread. This consideration has led me to believe that it would be very opportune for us to consider whether at this juncture the creation of a large investment trust would not render a very timely service. Of course, it could not be considered a "cure-all"; the present problem is too large for that. The War Finance Corporation (which in its structure is an investment trust with a limited span of life and restricted powers) is expected to bring substantial relief, and many other remedial measures will have to be devised. As one of these, however, a large investment trust, organized on a country-wide basis, might offer the two-fold advantage of, on the one hand, bridging the interval necessary for the better understanding and further development of foreign propositions, and for the creation of a better market, while on the other hand it would enable the small investor to buy the obligations of such an investment trust, representing diversified holdings closely examined by the most competent people and guaranteed by a very substantial paid-in capital stock. This, however, is predicated upon the thought that such an investment trust will be started upon a sufficiently broad basis to permit of a wide diversification and thorough investigation. It is obvious that no small concern could be liberal enough in incurring the heavy cost of thorough studies and examinations, and of employing the best experts. No investment trust would be safe or successful if forced to stint on this item of expense.

We must not underestimate the difficulty of raising the capital required, and of creating an adequate organization for the sale of the trust's obligations to the smallest and largest investors all over the country. It would appear, however, that both our export industries and our banks would have a very vital interest in seeing a project of this sort materialize. He who controls foreign steam and electric railroads, telephone or telegraph lines, electric light plants, mines or other industries, is naturally best equipped to secure for his country the large orders for supplies that go with the maintenance of such plants, and the requirements of the people operating them.

Where foreign countries are unable to sell their own obligations either because their credit is not sufficiently well established, or because governments do not wish to increase their indebtedness to us, or because the limit has been reached of the amount of their own bonds that we can absorb on acceptable terms, they may have to choose between several courses:

They may increase their interest rates, and permit their foreign exchanges to decline in our markets to such a degree that the American dollar will eagerly cross the ocean tempted by these favorable terms of employment, or they may reduce their purchases from us (and the higher the premium of the dollar in their lands, the more they may discourage such importations), or they may sell us the foreign plants and assets they own. There is a limit, though, to which a country may safely permit its foreign exchanges to decline and its money rates to rise. If these limits are disregarded, distrust may be engendered strong enough to drive foreign money out instead of drawing it into the country. There is a limit, too, down to which a country may restrict its importations of raw materials. Many a country may be expected, therefore, to reach the point where it may prefer to sell its plants or assets in other foreign lands, or offer us a joint ownership in them, or a partnership in new enterprises at home or abroad. Just as European capital crossed the seas and developed the transportation systems in North and South America, in Africa, India, and China, so the time has now come for American wealth to do its share in rebuilding the world, and to open new avenues of enterprise whenever—or must we say if ever?—political and social conditions settle down to a fairly normal state.

This dream, predicated upon the ending of a nightmare, cannot materialize, however, unless our men go out into the world and study carefully, courageously, and sympathetically conditions and opportunities in foreign lands.

It would appear as if the export associations, now being organized in large numbers, would soon realize that it will greatly facilitate the finding of new markets for their wares if in payment the foreign purchaser can sell us some assets that he holds. Active trade, in turn, will foster intimate banking relations, and nothing would seem more natural and logical at this time than to see the banks and these export associations, or the elements constituting them, combine in organizing an instrumentality for the study and financing of these foreign propositions in anticipation of the moment when tested and matured they may be absorbed by the American investor.

The time for immediate operation of such a trust has not yet come. With us the Victory Loan must first be placed and fully absorbed before we may find the basis for our future investment operations; the transportation question must be solved, reëstablishing $18,000,000,000 of railroad securities on their proper level, and the sale of the ships now held and being constructed by the government must be financed, before investment funds may become available for the purposes I have outlined on terms attractive enough to permit comprehensive operations. Furthermore, in order to reach a sound and solid level it will be necessary that England, as soon as her large governmental borrowing operations are completed, free her money market from all artificial influences. The removal of the peg in the sterling market appears to indicate a policy in that direction, and to forebode the next step, long advocated by Lord Cunliffe, of establishing higher discount rates.

The immediate future is subject to too many acts of God and man, to permit us to indulge in prophecy, but it is safe to say that the flow of American capital into foreign investments cannot be expected to assume large proportions until both here and abroad governmental finance operations have fairly reached their end, and money rates are permitted to find their own level, and, incidentally—another factor not to be overlooked—until peace has been signed and made effective. When these conditions are fulfilled, our investment rates ought to begin to trend downward, while England's rates might move upward to more closely approximate ours. A solid basis for harmonious and intimate coöperation will then have been reached between the two countries on which, in the near future, the main burden of financing the world's trade will rest.

While thus the moment for comprehensive foreign operations seems still remote, let us hope that the interval may pass sooner than most of us think. In any case, it is none too soon to prepare for that eventuality. It is easy enough to run along with the crowd that buys at top prices when things are booming, but the true art is to be able to discriminate and to discern the objects of permanent value when the outlook seems darkest. When the political horizon clears up, American business genius and courage will find the greatest opportunity they ever had. However, let us bear in mind that we are not dealing with a simple business proposition, but that ability to act at the proper time may bring hope and cheer to those looking to us for support, while unpreparedness and unnecessary delay will entail continued suffering for those on whom the hand of fate has rested heavily during these dark four years.

I have addressed myself in a somewhat one-sided manner to only one feature of the large problem. Within the compass of my ten minutes' remarks, and without abusing your patience, it is impossible to do more. I am fully conscious of the fact that it must be our ultimate ambition to create a direct wide market for foreign securities, and to use the indirect method of an investment trust merely as a useful auxiliary. If such a broad market is to be developed, the fullest protection of our people is a prerequisite. It means that, on the one hand, it is essential that we may confidently rely upon the unreserved sympathy and support of our government in protecting our rights in foreign lands; on the other, that measures must be taken to protect the small investor from the lures of reckless promoters, such as now overrun the country offering worthless securities in exchange for Liberty bonds. I had hoped that in every Federal reserve district a voluntary "Capital Issues Committee" might be organized which might certify to the *bona fides* of a prospectus, and that we could train the public to distrust any offering made without such certification. Failing the establishment of some such voluntary organizations, I am confident that Federal legislation will sooner or later be invoked resulting in red tape and delay such as, in the long run, are apt to be caused by rigid governmental control.

If broad open markets for foreign securities are created, I hope that our bankers will insist on receiving bonds payable not only in dollars, but also in the currency of the country issuing the security. We should have international bonds rather than foreign bonds. While for many years to come the home market for such securities may be of very little importance to us, we cannot foretell what the future may bring. We know, however, that for England it proved of the greatest value that in her hour of need she owned billions of dollars of foreign securities enjoying markets outside the British Isles, while France suffered from the fact that her loans to foreign lands had been made in special issues payable in francs, and having their exclusive market in Paris. International security markets are healthy adjuncts of international discount markets, they are important equalizers of trade balances, and I trust that we shall not neglect to provide this important part of Uncle Sam's equipment for his new career as a world banker.

APRIL 30, 1919

XXVII

GOVERNMENT LOANS AND TAXATION

Remarks at the Annual Meeting of the Chamber of Commerce of the United States, St. Louis

WHEN the War began, two schools of thought were dividing the social economists of the world with respect to the question of war finance. On the one side there were arrayed the apostles of the "all tax" dogma; on the other were found the preachers of the "all loan" gospel.

Experience has since proven anew that social economy is not an abstract science; but that, like law, it is a half science, whose theory must adapt itself to ever changing conditions. I believe it is safe to say that if Napoleon I came back to-day he would find our method of war finance further removed from what, barely one hundred years ago, were his own practices than the ways and means by which Julius Caesar supplied his war chest. The development of the steam, electric, and gasoline engines, bringing all the world into close relationship by land, water, and air, the emancipation of labor and, last but not least, the development of deposit and credit banking have brought about economic changes of so far-reaching a character as to render inacceptable for us to-day the classic rules laid down by Adam Smith, John Stuart Mill, or Ricardo, much as they fitted their own times.

In this question of loans vs. taxation the imponderables, moreover, appear to play a decisive rôle; the length of the War, its intensity and scope, and the economic reserves accumulated by the countries involved, are factors of vital importance.

Countries starting out on the "all tax" theory have been taught by experience that it was impossible for them to raise the funds required without recourse to huge loan operations and, conversely, the "all loan" champions among the nations found, much to their own detriment, that it was a foolhardy and suicidal undertaking to try to finance a war without raising a large portion of its cost by increased taxation. The end of the struggle finds then the best economic minds in substantial agreement on the point that in financing a world war exclusive recourse must not be taken either to loans or to taxation, but that it is the task of wise statesmanship to ascertain the proper proportion to be observed in resorting to both methods in raising the necessary funds.

While it may be accepted as a benefit that through the issue of long-term government bonds the final distribution of the burden of paying the war cost is spread over a period of years and thereby shared, to a certain extent at least, by the coming generation, it must be conceded that excessive government loans, contracted for non-productive purposes, and issued faster than the savings of the people can absorb them, are contributing factors in creating pernicious inflation of prices, which in turn constitutes the most subtle and inexorable form of taxation.

On the other hand, we can readily see the absurd and impossible situation that would have resulted from an attempt to raise our entire war contribution through taxation. It is obvious that any extreme and confiscatory form of taxation would destroy the very source from which government revenues must be expected to flow.

Disastrous results follow, therefore, from excessive government loans as well as from excessive taxation. The problem and the art is, then, by applying both methods and by coordinating them, to reduce to a minimum the evil consequences of the excessive use of either, and to distribute unavoidable hardships in as equitable a manner as possible.

The task is one not of theory, but one of experiment and practice, and, I understand, the object of this discussion is to elicit information as to whether or not taxation in its present form and scope is doing undue violence to certain industries or trades, endangering thereby economic development vital to the future health and growth of the country.

The question in its larger aspect calls for the further inquiry as to whether present taxation may not tend to reduce so drastically the investment power of the heretofore well-to-do classes that the spirit of enterprise might thereby be seriously affected. There is hardly any question before the country deserving a more careful and earnest study than this.

If, owing to drastic taxation, the large incomes may no longer be relied upon to furnish the bulk of the investment funds necessary to finance our economic growth, we must look to those possessed of smaller incomes and subjected to only moderate taxation, to produce the main portion of the savings available for investment. This can be done only if we succeed in letting the gospel of thrift penetrate deeply into the minds of the masses. The Liberty and Victory Loan and War savings stamp campaigns were able to render invaluable service in this respect as long as the government was the main employer and borrower. Will it be possible to convince the workingman, the farmer, and storekeeper, that it will be necessary for him to continue to finance his employer when private enterprise resumes the place occupied by the government during the last few years? Unless that can be accomplished, our future progress is in serious danger of being retarded.

The fundamental remedy for our economic ills lies in thrift. Thrift spells increased production and decreased consumption; the resultant saving, in goods or money, furnishing the means for the country's recuperation and future growth. The world balance sheet has been watered by the issue (for unproductive purposes) of over $250,000,000,000 in circulation and securities. In some countries this process of inflation has gone so far that bankruptcy or repudiation remains the only way out. Happily our economic strength is such that we may confidently expect new wealth to be created rapidly enough to purge our balance sheet within a reasonable time. These new assets will then either set off or pay off our debts incurred during the War.

As this process of deflation takes place, prices will find their proper levels, and our problems of equitable and reasonable taxation will solve themselves.

The creation of new assets, however, is predicated upon individual and national economy. The more we keep our "operating expenses" down, the less in the production of this new wealth we squander through unnecessary consumption, and the more money we spend for permanent and productive things, the faster this healing process will take its course. It is not an automatic process; it is one that can only succeed within a reasonable time if carried by a nation-wide will and understanding. It does not contemplate making us a nation of misers, but rather a nation of intelligent spenders.

The most immediate and most tangible result of successful economy would be the elimination of the item "loans on government securities" from the balance sheets of both our banks and trust companies and the Federal reserve banks. In eliminating these items we strike at the very root of inflation. We began the Victory Loan campaign with, it is estimated, approximately $4,000,000,000 of undigested government bonds, not counting the billions of United States certificates of indebtedness held by our banks. Even though the Victory Loan should be absorbed entirely by the savings of the people, as we earnestly hope it may, the cost of winding up the War, amounting to many additional billions, will still remain to be financed. It is likely that short-time certificates will be used for that purpose, that the bulk will be carried by the banks, and that ultimately they will be paid off largely by receipts from taxation. Shall it be one year's taxation or two years', or more, or shall a portion of these future short loans ultimately be funded into some long-term bonds? These are interesting questions whose proper solution will greatly depend upon the speed and scope with which these bank loans and holdings will be liquidated through voluntary savings. The thorough absorption of these government bonds is the main object to be accomplished, and if this distribution is not effected by voluntary effort, it will have to be brought about through taxation.

The more rapidly our national debt is genuinely paid for by saving, the sooner shall we be able to get away from the necessity of drastic taxation. When once our government loans are definitely absorbed, the question of taxation for the purpose of amortization may be considered from a very different point of view. Whether it will be advisable then to tax Peter to pay off Paul, will depend upon the question of whether we shall then find that by amortizing our debts we should be taxing the poor to pay off the rich, or the rich to pay off the poor. We should also have to consider whether Paul was likely to squander the money he would receive from Peter, or whether he would apply it to the greater advantage of the country as a whole. It would seem wise, therefore, that before the government's short-time borrowing is liquidated we should not embark upon a general plan of amortization of our long-term loans. That, except as far as desirable for the protection of the price of our loans, would be unduly overloading our burden of taxation.

Our definite program of amortization, I believe, can be dealt with intelligently only when our post-war picture is more clearly before us with respect to distribution, prices—including money and wages—and general world conditions.

Relative inequalities in our general scheme of taxation may well engage our attention at this time, calling for adjustment as affecting individual groups of industries and trades. It is our duty to see to it that taxation, a problem of redistribution, does not degenerate into retribution. But, we cannot play the part of helpful critics unless we boldly envisage the question as a whole, in all its scope and gravity, and unless we realize that only through the united and persistent efforts of every one of us may we expect to lighten one another's burdens.

Prosperity based upon inflation is largely fictitious. It is a fact that the pre-war dollar has been cut in two. Those living on fixed income, or those enjoying returns from savings accumulated before the War, realize that at present they own only half of what they had before. And they will remain in that position unless we consciously and consistently do our share in reëstablishing the purchasing power of the dollar.

The greater the waste of governments during the War, the more determined must be the efforts of the individual by increased saving to counteract the disastrous consequences of the government's fiscal operations.

But a country called upon to submit to the heaviest possible burden of taxation is entitled to a very definite assurance that after the establishment of peace its government will, with equal care, weigh every penny it appropriates and spends, and that the government will thus do its own full share in readjusting the watered balance sheet.

I believe that I am voicing the sentiment of the majority of all thinking Americans when I say that in this respect the hour calls for thorough reform. A more careful and scientific study of our national receipts and expenditures is required than has been given heretofore. Congress must relegate to the past its haphazard methods of appropriating expenditures through numberless committees, all acting independently of one another, and without having any comprehensive picture of what are the available revenues. It is high time that a national budget system be adopted, such as enjoyed by every other nation, and that before granting the appropriations called for by departments, boards, or commissions, a thorough investigation and report be made as to what revenues may safely be counted upon.

Receipts and expenditures should be brought into harmony and a complete budget should be examined and prepared by non-partisan experts who would make their report to the President, before the latter sends the budget to Congress for further action.

Congress, it is hoped, will take the necessary steps to concentrate in a few committees the responsibility of passing upon and perfecting the budget and of securing action upon it at an early period of the session, and before additional appropriations can be considered.

The Chamber of Commerce of the United States, through a previous vote, stands committed to the recommendation of a national budget system; it would appear most timely to renew our efforts in this respect.[1]

In view of the growing magnitude of our government's operations, directly and indirectly affecting the pocket book of every citizen, it is no more than wise and just that there should be established a staff of men correlating the fiscal operations of the various departments and branches of the government and, after fair-minded expert examination, making their report without fear or favor. How far to apply taxation, how far to resort to loans, when and how far to apply taxation to amortization, are only a few of the many puzzling problems that would engage the attention of those charged with the duty of preparing and paring a national budget.

Presidents, Cabinet members, assistant secretaries, senators and congressmen come and go, the intricate question of raising our vast revenues in a scientific, fair, and economic manner has come to stay. The creation of non-partisan expert bodies should be encouraged, representing the permanency and continuity of knowledge and policy in matters of business, as against the free and rapid fluctuations inherent in the political life of a healthy democracy. Eventually we may hope to see established a permanent "business Cabinet" composed of

[1] A "National Budget Committee" was organized on March 15th, 1919; its founders were: John T. Pratt, Chairman, Henry L. Stimson, Benjamin Strong, Joseph P. Cotton, and Paul M. Warburg. It continued its campaign until a National Budget System was adopted.

the heads of our non-partisan boards and commissions and advising the President in matters of technical administration to be judged from a non-political standpoint, in a similar manner as his political Cabinet deals with problems to be treated from a more partisan point of view. A consideration of that question, tempting as it may be, would lead us, however, beyond the topic of the discussion which these few remarks of mine are designed to invite.

MAY 23, 1919

XXVIII

SOME PROBLEMS OF THE INVESTMENT BANKER

Address Before the Bond Club of New York

WHEN, several months ago, your President did me the honor of inviting me to address your club, I asked him kindly to put me down for as late a date as possible. The Great War having created a long record of wise predictions disproved by subsequent events, I was very anxious to avoid speaking to you at a time when venturesome prophecy would still be my business. We agreed, therefore, that I be permitted to address you at the end of May, when I expected to see the Peace Treaty signed and ourselves in a position to draw some definite conclusions as to the future picture of the world and our own duties and opportunities therein.

But, here I am, "fooled again" and much embarrassed at being obliged to talk to you at the worst possible moment, when our problems in the light of existing conditions have been reviewed at innumerable conferences and from all possible angles, while the new chart of the world—geographical, political, social, and economic—is still incomplete and does not yet admit of a mature and free public discussion. To attempt to pierce the mist that still shrouds our view across the Atlantic would, therefore, be a hazardous and unprofitable undertaking for me at this time, and I believe it a dictate of wisdom rather to confine myself to a discussion of "troubles of our own." I trust that I may count upon your forbearance and sympathy if in these circumstances my remarks of necessity cover a field already thoroughly plowed over. But the question of what seeds we shall sow in the furrows still remains open as an interesting subject of study and speculation.

When my secretary told me that your club was telephoning to inquire what subject I had chosen for this speech, I answered offhand, "Problems of the Investment Banker," but changed it at once into "Some Problems of the Investment Banker," not only because it was the more correct and modest title, but because I felt from the bottom of my heart that there are, indeed, "some" problems facing you in the future.

The amazingly quick development of our country has brought about many kaleidoscopic changes which baffle the imagination. I do not believe, however, that any American profession has witnessed a more rapid evolution and a more fundamental revolution than that of the investment banker; and this phenomenal course, vastly accelerated through the War, has not yet reached its point of culmination.

Looking back to conditions prevailing only one generation ago, we find a very small group of investors and a very small list of investments. Government bonds played a rather unimportant part; municipal bonds played a rôle of some importance. The main energies of the investment bankers were concentrated, however, upon railroad financing. Then came the period of industrial development, which opened a new investment field, the volume of transactions increasing steadily with our growing national wealth. Now over twenty billions of government obligations have outdistanced our eighteen billions of railroad securities, and a new factor of importance looms up on the horizon—the foreign investment.

But it is not only in the character and volume of securities that this great development has taken place; even more impressive has been the change in the quality and the quantity of the investors. As a consequence of the War the creation of wealth has proceeded on entirely new lines, and to-day we find many millions of bondholders, where in the past we had only 200,000. Where heretofore investment banking addressed itself primarily to the comparatively few possessed of large incomes, taxation to-day strikes so heavily at the revenues and inheritances of the so-called well-to-do classes, and interferes so drastically with the accumulation of investment funds on their part, that successful distribution of large amounts of new securities can only be carried on by following wealth into the millions of small rivulets and channels into which it now flows, and where it is less subjected to the exactions of the tax collector. There is no doubt that the present extreme form of taxation cannot long be maintained without doing great harm to the further development of the country, and we may well expect that some modification will be made in the near future. But I believe it is safe to assume that in a large measure the new conditions have come to stay, and that we may not hope for a healthy and permanent adjustment between capital and labor unless the working classes are so situated that they can save and put aside in investments a fairly substantial portion of their earnings. In this ability of theirs to save and invest lies one of the most important means of bringing back to a more normal condition our present badly distended financial structure.

It is not possible in these short remarks to dwell upon the question of inflation. But we all realize the ominous part played in this connection by the approximately four billions of undigested government securities, estimated to have been carried by banks and bank loans at the time of the beginning of the Victory Loan campaign. We may assume that this item has since been substantially increased. I believe that it is one of the gravest and at the same time most puzzling problems of the investment banker to find ways and means of furthering the absorption through the savings of the people of these floating government loans. Unless that task is accomplished, it is to be feared that these undigested bonds will throw a chronic blight on the investment market. I am confident that money rates and the purchasing power of the dollar will not find their healthy and fairly permanent level until this process of absorption is completed. Not only must these bonds be absorbed, but after they have found their solid resting places, a healthy demand for them must be continually stimulated so as to increase their price level, and to create for them that attitude of a preferred investment necessary in due time to bring about conditions favorable for the conversion of the Victory notes. The alternative of such voluntary absorption would be a comprehensive plan of amortization, which could be carried out only by means of heavy taxation.

Next in importance are the problems of railroad and foreign financing. Both, strange to say, are closely interrelated. For as long as our railroad securities sell on an abnormally high interest basis, it is evident that we cannot, on a comprehensive scale, offer good foreign securities at prices that would make them attractive to our own investors, without at the same time appearing prohibitive to the foreign borrower, or exorbitant as compared with the prices which other competing countries might be able to offer. It is most important, therefore (for this and for many other reasons which I need not enumerate), that our railroad problem be solved in a way that will firmly reëstablish our badly mangled railroad credit.

I think that I am voicing the views of most of those who have followed the trend of the discussion of remedial legislation when I express to you my own firm belief that a just solution is honestly being sought by those on whom the duty and responsibility rests in the first degree, and that we may well hope to see satisfactory results accomplished in the near future.

It is most encouraging to note how rapidly and how firmly during these last few months public opinion has crystallized into the impatient and determined demand that the railroads be returned to private operation after enactment of legislation assuring for them proper protection and a basis permitting them to live and expand. In this respect, the President's message has put a quietus upon the apprehension harbored by some that the railroads might be returned to private operation abruptly and without previous remedial legislation. On the other hand, the President has now squarely placed the responsibility upon Congress to frame and pass a railroad reform law within the next six months. I believe this can be done.

A general agreement appears, furthermore, to have been reached on the part of most students of the question that future legislation must contain a clear and binding definition of what is to be considered the fair value of the carriers and as to what is to constitute an adequate return on such fair value, and, furthermore, that the law must contain an unqualified assurance that this adequate return cannot be regulated away from the carriers. Finally, there seems to be a consensus of opinion that railroad reform must bring about a unification of our hundreds of individual railroads into a small number of large systems operating under Federal charters, and competing in service, though not in rates.

We may take it as admitted, I believe, that the majority of the American people do not favor regional railroad monopolies, but desire a system of strong and competing railroads. This leads to the inevitable conclusion that the law must leave an opportunity for earnings sufficient to preserve and encourage private enterprise and rivalry, though on the other hand it is conceded that the interest of the public requires a restriction of railroad profits in case they exceed certain limits.

This is great progress auguring well for the finding of a sound and fair solution, even though we must realize that it is one thing to announce the broad principles and another to master the intricate questions of technique and detail. These, however, will appear much less puzzling when the complex problem is properly studied in its three phases, or stages, of proximate development. They are: the final stage of possibly between twenty and thirty consolidated Federal railroad systems operating under a rate making rule based on the established aggregate value of the properties grouped in traffic sections; the intermediate stage covering the time necessary to complete consolidations and valuations, and finally, the first stage, including the immediate steps necessary to disentangle the railroads from government operation and to put them back on their own feet. I am very confident that where there now appears to prevail on all parts a fair spirit, a clearer understanding and the earnest desire to find the proper remedy, we shall succeed in securing it at a fairly early date and on a sound basis.

No doubt some attempts will be made in Congress to reduce below a proper and equitable level the "adequate" return to be permitted to private capital. But safety lies in the consideration that any policy of undue niggardliness would defeat the very object of the legislation, which is the reëstablishment of railroad credit and the preservation of a healthy spirit of private efficiency and enterprise. Private capital realizes that it must be satisfied with the very minimum that will accomplish these ends; on the other hand, any encroachment upon that minimum must needs lead to government ownership and operation. Any unwise attempts in that direction are therefore bound to defeat themselves. The country begins to understand that where the price of goods increased by about 200 per cent since 1896, the cost of transportation in the same period is estimated to have risen only by about 40 per cent for passenger fares and 20 per cent for freight rates. It begins to comprehend, furthermore, that one year's increase in wages, estimated at $1,250,000,000, equals about three times the total amount of the annual railroad dividends paid by all railroads combined. And when it is fully appreciated that the question of successful or abortive legislation may depend upon the grant or denial of an additional return of less than $100,000,000 the people will leave no doubt as to their wishes in the matter. That addition, if it leads to the establishment of a healthy and permanent basis for private railroad operation, would prove in its direct and indirect results one of the greatest savings ever made by the country.

A satisfactory solution of our railroad problem, going hand in hand with the absorption of our floating government bonds, should, in due course, bring about an enhancement in the price of our government and railroad obligations, which in turn should lay a sound foundation for the development of an important market for foreign securities. If our government bonds went back to par and our railroad securities gained back only half of the shrinkage in value sustained during these last years, the nation would recover about $3,000,000,000 in taxable wealth.

The large sums the world owes us for interest on our foreign bonds, and the sums due us in payment for raw materials and goods, as we all know, will force American money into foreign investments in order to keep our goods moving and the balance sheet of the world reasonably square.

As we succeed in training the masses, not only to absorb the floating government bonds, but, beyond that, gradually to become investors in other first-class securities, to that extent we shall relieve the banks and the large investors.

The billions thus released could go into foreign and other new ventures. But it will take time to develop a market for foreign securities commensurate with the offerings with which we may have to deal, and it is highly desirable to devise ways and means to bridge the interval. I believe, therefore, that it would be of great advantage if by the creation of powerful investment trusts we could develop machinery enabling the timid investor, and particularly the "little fellow," in a modest and safe manner to become a holder of foreign securities. It would lead too far to go into a detailed discussion of this interesting problem. Moreover, it would be reiterating what I have stated on several occasions.

To a group of experts, such as constitute this audience, it is obvious that when large investment trusts are organized, whose stock capital forms a substantial guarantee fund, and whose investments are largely diversified and made only after careful investigation, the obligations of such trusts might well be considered a proper investment for a moderate portion of the savings of the people. While the purchaser would not enjoy the full benefit of the higher interest return, as would accrue to him from a direct investment in these foreign securities, he would be so much more effectively protected by the guarantee of the stock capital, by the wide spread of the risk, and by the expert examinations applied in selecting the investments securing his bonds.

I believe it to the interest of the investment bankers to consider steps jointly to deal with these foreign problems, which generally require a more extensive and expensive examination than any individual house would be willing to venture. My own experience in Europe has taught me that the operations of investment trusts or syndicates of this character are likely to lead to disappointments unless they are organized on a basis broad enough to permit of a very liberal attitude, not only in studying new projects, but also in abandoning them freely, in spite of the expense incurred, in case the result of an investigation does not prove the venture to be sufficiently safe and promising. But, has it occurred to you that perhaps it may be possible to create a link between the problems of the investment trust and the campaign for the ultimate absorption of our government bonds?

The question is still unsolved: Who, after the dissolution of the Liberty Loan organizations, is to shoulder the task of placing the floating government bonds and of regulating the market in a manner permitting of a moderate remuneration for those effecting the sales? It involves a gigantic task, in the successful accomplishment of which the country is vitally interested, and not the least, the investment bankers themselves. If the investment houses all over the country would join in the formation of a huge investment trust, and if that organization were to concentrate its first efforts upon the distribution of government bonds, taking them from the War Finance Corporation (which would regulate the market) and placing a series of trust obligations, secured by government bonds, where small denominations or different maturities should be required, would they not lay the foundation for a continuous "save and invest" campaign of unprecedented effect and scope? And would they not create an organization which, if properly safeguarded, after the absorption of the floating government bonds, could become an investment instrument of the most vital importance to the country? Might not that prove worth while, even though it involved a year's work, or two or three, at probably very insignificant remuneration? I am not presuming to recommend a definite plan; but we cannot blink the fact that we are facing here two very real problems which will have to be dealt with, and I felt that it might not be amiss to suggest a thought which possibly might appeal to your imagination.

But irrespective of whether or not we deal with these problems singly or combined, in teaching twenty million people to become investors, we are taking upon ourselves a very grave responsibility, because in doing so we run the risk of making them the targets of unscrupulous promoters. We are all familiar with the attempts recently made to induce small owners of government bonds to exchange their holdings for worthless oil stocks and similar securities, or rather insecurities.

The more foreign investments of excellent quality are introduced, the greater will be the temptation for crooks to slip in and palm off fake bonds or stocks on innocent victims. The era of expansion of our foreign trade, which seems to lie ahead of us, will offer unprecedented opportunities in this respect. To my mind, it is urgently necessary to provide the best possible machinery to protect the country against such frauds. Federal or state laws enacted to accomplish this aim, if they are to be effective, would have to include all security issues. In the long run they are likely to develop red tape, delay, and government interference which, under political pressure, some day might prove highly detrimental to the country's interest.

On the other hand, unless investment houses themselves devise the proper safety appliance, there is no doubt that conditions may arise calling for very drastic Federal or State legislation.

Present methods are frequently loose and there does not exist any machinery by which bad practices can be curbed. Writers of advertisements may emphasize and omit what suits them best, and printed underneath their often meager and arbitrary announcement they insert a statement that the "information is not guaranteed but is based on statements from what they consider to be reliable sources." We have recently seen some samples of the legislative measures likely to be devised, and from these first proposals we may conclude that any State or Federal legislation will be far-reaching. In France and Germany such legislation exists, and in order to secure essential information the laws require at the same time a mass of unessential material. It is difficult to imagine how any other result may be expected whenever requirements of this sort are formulated in a law. As a consequence, a prospectus in these countries is a most formidable document, filling many pages, and introductions of securities are very costly and subjected to great delays. In these circumstances, I should like to renew a suggestion made last year, that, of their own free will, investment houses get together in all Federal reserve districts and ask the Federal reserve agent and governor of their respective Federal reserve bank to agree to serve on a voluntary committee of three, or five, which—much on the lines of the old Capital Issues Committee—would be prepared to examine a prospectus before the securities are offered, and would certify that certain papers necessary to authenticate the facts stated in the prospectus have been filed.

The main task of the committee would be to see to it that the figures and statements contained in a prospectus be authentic, and published over the signature and under the responsibility of the corporation or government issuing the securities, or of the investment house offering them, and that, so far as the committee can judge, important facts have not been omitted, and that statements printed in the document be supported by facts.

It would soon be generally understood that, like the Capital Issues Committee, the new Securities Committee would not be passing upon the merits of the offer, but that it would simply see to it that certain information must be given and that such facts as are stated in the prospectus are authentic, and given under somebody's responsibility.

Any State legislation would have the very serious disadvantage that one State might legislate and another might not, and that as a consequence bankers of the State with loose methods might profit at the expense of those domiciled in a State which has enacted legislation. Undesirable consequences of this sort would be avoided if the investment bankers of all Federal reserve districts would act together, and if all Federal reserve banks would coöperate. The Federal Reserve Board might be invited to assist in the matter and see to it that uniform methods of procedure be applied in all districts. I should very much misjudge the Board if it would not be glad to lend a hand in the matter.

If committees of this character were organized, the public could soon be warned that no security should be considered unless the prospectus or offering showed the certification-number of the Securities Committee of the district.

I can well imagine that each district would engage the services of a permanent secretary, who after a while would become an expert in handling these questions.

Unless something of this sort be done, it is only a question of time for some grave disappointments or scandals to occur, discrediting future issues and interfering with the free and healthy development of our security markets. If, on the other hand, the strong and reputable investment houses, of their own accord, subject themselves to whatever little delay and red tape may be necessary in dealing with their issues, they will, in the long run, best protect their own interests; because in doing so they will help in keeping the crook out and preserve a clear field for those who are not afraid to have the searchlight turned upon the securities they are about to offer.

It has not been the object of this paper to suggest specific solutions, but rather, as its title indicated, to state the problems. They are real and deserving of your earnest consideration, and I thank you sincerely for giving me the opportunity of presenting them to you.

JUNE 10, 1919

XXIX

ACCEPTANCES IN OUR DOMESTIC AND INTERNATIONAL COMMERCE

Address Before the National Association of Credit Men at Detroit, Mich.

THIS is the third time you have honored me with an invitation to address a Credit Men's convention, and genuine, indeed, is my appreciation of your generous willingness to listen to me again. All the greater, however, has been my embarrassment to write for you a new variation of the same old song, and to find a tune that would not sound stale to such patient friends.

Barely a year ago it was my privilege to speak to you at Chicago on the topic of trade acceptances, in the educational propaganda for which, from the inception of the movement, your Association had taken a leading part. Since then the Trade Acceptance Council has enlarged its name and scope into the "American Acceptance Council", whose widened field of activity now also embraces the "bankers' acceptance." This was a natural evolution and followed as the logical consequence of our country's increasing interest in world trade and world finance. The trade acceptance, in its most important aspects, relates to our domestic business; the bankers' acceptance renders its primary service in financing foreign trade. What could have been more timely, therefore, than for the Trade Acceptance Council to adjust its gait so as to keep step with Uncle Sam's rapid strides into foreign fields?

I need not assure you that this new departure could not possibly imply that the Council's interest in the development of the trade acceptance has lessened. No such thought could occur to anyone conscious of the fact that our domestic trade commands a position of vastly greater importance than our foreign trade, both as to volume and character. The enlarged program of the Council simply meant the inclusion of the bankers' acceptance in addition to, not in substitution of, the trade acceptance, and the accession to the old Council of new members chosen from among the most prominent experts in foreign banking in the leading financial centers of the country. The Credit Men's Association continues to be represented on the Council by your energetic Secretary-Treasurer, Mr. Tregoe, and I feel certain that in its wider aspect our undertaking will enlist an even keener interest on your part than in the past.

The American Acceptance Council, upon your invitation, and in anticipation of this conference, held here yesterday an all-day session, when both the trade and bankers' acceptance were carefully discussed in highly instructive addresses and debates. Some of you were present at these meetings, and to all interested the speeches will be made available in printed form, so that it would be inadvisable for me now to go into a detailed discussion of the technique of the acceptance problem. I believe you would prefer that I survey the field in broad outlines, with an incidental sketch of the future plan of operation of the Council.

I shall touch only slightly upon the question of trade acceptances. You permitted me to go fully into that phase of the question about a year ago, and I have very little to add, except that nothing has developed to alter the views which I then expressed, and that quite a good deal has happened to confirm them. A constantly increasing number of merchants testify that by adopting the trade acceptance they have simplified their operations, strengthened their financial security, and thereby their general ability to do business. It is true that a few opponents continue an antagonistic propaganda, but their attitude reminds me of the resistance encountered at the time when Federal reserve banks were making their greatest efforts to secure the membership of state banks and trust companies. Old-fashioned state bankers then used to sit up nights figuring out to a nicety what they would lose by joining the Federal Reserve System. Detailed theoretical calculations were submitted and made the basis of their arguments. But while they were thus making out their hypothetical cases, those among them who had vision and were capable of a more national point of view joined the System. When, later on, groups of banks were invited for a discussion of the pros and cons involved in membership, Federal reserve officials were mindful to have present some state bank or trust company that had joined. These new converts invariably reported the fact that membership had not only given them greater security, but that their new affiliation had resulted in increased earnings rather than losses. That always closed the discussion. On the one hand we had hypothesis; on the other we had facts.

I am strongly inclined to believe that the trade acceptance discussion has reached a similar status. The hundreds of firms basing their evidence not on theory but on results actually achieved and benefits realized, tell their own convincing stories.

When, as Chairman of the Council's Executive Committee, I recently addressed its first executive committee meeting, I tried to sum up its views in the following statement:

> We are preaching the gospel of the trade acceptance for no other purpose than that we believe its use makes for sounder business and banking conditions. We do not say that single-name paper is not good, or illiquid; but we may fairly say that the trade acceptance is better and more liquid. We do not say that the trade acceptance serves all purposes and that all cash sales and all cash discounts ought to be avoided; but we do say that where business is not done on a strictly cash basis, the trade acceptance will be found the safer, sounder, and, in the long run, more economical method than the open account.

> Indeed, we believe that it is so much of an improvement over the open account that in some cases sellers, at present sacrificing a very heavy cash discount for the purpose of avoiding the dangers and inconveniences of open accounts, might find it to their advantage to consider the economy involved in the use of the trade acceptance when dealing with customers of strong credit.
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> We do not want to appear as wishing to force upon anybody the adoption of the trade acceptance, unless he considers it as serving his better interest. We do wish, however, those who can profit from the method to study it carefully and not to hesitate to adopt it. The American Acceptance Council's interest in the matter is that whatever makes for better morals in business and for better credit and banking conditions is a decided benefit to the United States.

It is true that during the last year the progress of the trade acceptance has not been so rapid as it might have been under ordinary circumstances; for while it has gained new converts in large numbers, measured in volume, its growth has been greatly retarded by the anomalous war structure of our discount rates.

In normal times Federal reserve banks would be expected to establish rates for bankers' acceptances substantially lower than for single-name paper, and about half-way between these two there should be the discount level for trade acceptances. That was the original scheme of the Federal Reserve Board when formulating its principles with regard to the rate schedules for the various classes of paper. Our entrance into the world struggle intervened, and in order to facilitate the government's war financing, justly entitled to our very first consideration, rates had to be established favoring the so-called war paper; that is, bills secured by government certificates or bonds. This led to an incongruous rate structure resulting in the present abnormal condition when about 80 per cent of all the bills held by the Federal reserve banks—that is about $1,800,000,000 out of $2,150,000,000—consists of war paper. The total loans and discounts of member banks amount to roughly

$13,500,000,000. It is clear, therefore, that when engaging in rediscount operations with the Federal reserve banks in order to provide for their commercial requirements, member banks primarily used their war paper, inasmuch as it commands the lowest of all rates. This rendered illusory one of the main advantages originally intended to be derived from the ownership of trade acceptances and bankers' acceptances—that is, a preferential discount rate.

Indeed, the differential between Federal reserve bank rates for commercial paper and bankers' acceptances having shrunk to approximately one-half of one per cent, it no longer leaves between them adequate space for a third and effective intermediate rate for trade acceptances.

It has now become the country's very serious duty to liquidate as rapidly as possible the war paper and holdings of government bonds in the hands of banks and trust companies. This item, representing undigested government bonds amounting, it is estimated, to more than four billion dollars, constitutes one of the fundamental causes of banking inflation. In order to promote their absorption by the savings of the people and in order to encourage thrift by compelling borrowers, if necessary, to reduce their loans, Federal reserve bank rates for paper secured by government bonds in due course will have to be raised. They would have to approach more closely the then governing rates for commercial bills, while rates for bankers' acceptances should be held at a rate sufficiently lower to provide for an ample margin in their favor against single-name paper. And between these two rates the trade acceptance rate should find its proper level.

As this process of absorption takes place, and as the government reduces the volume of outstanding certificates of indebtedness, acceptances may be expected to regain their proper position as the most available and safest pass-key to the facilities of the Federal reserve banks. Ultimately acceptances are bound to become the main investment and rediscount field for Federal reserve banks and this demand alone will create a large market for them at favorable rates.

It may take a year or two before this course makes appreciable headway, but it is to be hoped that at an early date we may see the beginning of a definite policy pointing in that direction.

In determining the future level of our bankers' acceptance rates, the British discount rate will play an important rôle. Sooner or later our rate and the British must be brought into a proper relation. It is impossible to predict exactly in what manner this will be accomplished. Our British friends at the end of the War have now established a gold embargo, while it may be expected that our gold embargo will be raised upon the signing of peace, if not at an earlier date.

England's future foreign exchange and discount policy is still undecided. At present there exist two divergent schools of thought: one, led by Lord Cunliffe, believing that foreign exchanges must be brought back to their pre-war levels by the establishment of a high British discount rate. That school holds to the old doctrine that high rates of interest will draw gold freely into a country enjoying a strong banking credit. If such a course were adopted, it might safely be followed by the lifting of the British gold embargo. The proponents of this policy are opposed, however, by another group of British political and financial leaders urging the maintenance of the gold embargo, preserving present artificially low interest rates under its protection, and allowing sterling exchange to remain at a discount in several foreign countries, particularly in the United States. It is difficult to see how such a policy, in the long run, may be expected to bring about a lasting cure. Whether or not it may be advisable for England to continue it as a temporary device is a matter that only British leaders can judge. My own belief is that sooner or later England, whose banking prestige and power have rested so largely upon the tradition of a free gold market, will adopt a course leading towards the lifting of the gold embargo, that is a policy of higher and effective discount rates. To me it remains a riddle how note-issuing banks, on both sides of the water, could hope to effect "deflation" unless they take steps not only to arrest a further increase in their investments, but indeed to decrease them. And this they can achieve only by placing their active official rates above those of the open market.

It is an evil condition that prolongs the necessity for governments to issue billions of bonds or currency for the purpose of paying millions of people who are idle. It intensifies the inflation of prices because it continues to swell the outstanding amount of money and credit, while, at the same time, idleness interferes with a proportionate increase of goods. But this state of things, bad enough in itself, is aggravated most viciously if, in order to place government bonds (issued for unproductive purposes) upon a low interest basis, the general level of rates of interest is artificially lowered, and bonds, instead of being absorbed by savings, are carried by manufacturing new credit, be it through added bank loans or circulation. "During war the laws are silent," is an old Roman saying, which applies with equal force to economic laws. But the War, happily, is ended and we must now boldly face the question of whether we wish unconditionally to surrender to inflation and accept it as a finality—that is, sacrifice all services rendered in the past to the services of the future—or whether we are determined to work towards a readjustment in the direction, at least, of the pre-war level, though nobody expects us even approximately to reapproach it.

It is a pathetic fact that peoples, like children, apparently can learn only from their own experience, but not from the experience of others.

We know that war prosperity usually ends in a crash; shall we be able to avoid it?

If such be our wish we must beware of booms based on a false prosperity which has its roots in inflated credits and prices.

It is an ungrateful and at present an almost superhuman task to stop the easy flow from our credit reservoirs that creates the enlarged foundation for our growing credit pyramid.

While the Federal Reserve System proved our salvation during the War, and while our imposing reserve power may be destined to play a most important rôle in meeting some of the grave problems that still lie ahead of us, I believe the moment is near at hand when we must not permit this reserve to be further encroached upon for the sake of increased credit expansion at a time when the healing process must be sought in contraction. To apply that remedy may be a harder task than to follow the lures of fictitious prosperity born of easy money, but in the long run I believe it will be a more prudent and more charitable strategy. Such a course would not imply that we should be slackers in shouldering our full share in attacking and solving the world's burning economic problems. It means only that we must manfully and planfully husband our resources instead of squandering them by personal extravagance and headlong speculation—and that we must concentrate our efforts on doing the big constructive things with wealth bottomed upon solid production and saving, instead of resting it on the quicksands of further inflation of credit and prices.

We cannot formulate any definite opinion as to what will be the future level of our own acceptance rates until we have a clearer picture with regard to the scope of our future government requirements, the amount and the terms of sale of United States certificates of indebtedness to be kept outstanding in the future, and until we know what England's discount policy is going to be.

It is probable that in due course our discount rates for bankers' acceptances will be on a par with (if not lower than) the English acceptance rate. Whether our rate will drop down to theirs, or theirs move up to ours, or whether possibly we shall meet half-way, cannot be prophesied until governments and note-issuing banks have reached definite conclusions with respect to their future financial policies. It appears, however, to be a reasonable expectation that (even though we should lift our gold embargo and England should not), we may hope to be in a position to maintain an acceptance rate which will enable us to meet the British rate in world markets, and on a level substantially lower than our commercial paper rate, whatever it may be at that time.

As a consequence of the War, the indebtedness of other countries to us has become such that if these foreign nations are to be kept in a position to buy our goods, we shall have to grant them credits or purchase their obligations or other assets. We are not yet fully equipped for the placing of foreign securities on a large scale, moreover the credit of foreign governments in many cases is least well established in countries where the demand for our goods and credits is most urgent. But where government credit may be found inadequate, private credit may be of sufficient strength. People must eat and clothe themselves, and certain industries in such countries may, therefore, well prove strong enough to warrant the granting of short credits financing the movement of our products to them or theirs to our shores.

American bankers' acceptances may play a most vital rôle in meeting this emergency and promote thereby the all-important work of reconstruction, which has been so much in the people's minds but has been so slow and elusive in taking tangible form. Our banking system has attained phenomenal strength within an unprecedentedly short lapse of time. There is a vast opportunity for American banking enterprise to go out all over the world and to enter into new relations, promoting not only our trade and industry, but at the same time rendering vital services to the countries at present sadly in need of our help.

We may justly be proud of the spirit of enterprise shown by our banks in dealing with these new problems. The number of American branches and agencies opened in foreign lands exceeds seventy at this time, and is growing every month. They are now established in South and Central America, Asia, and in Europe. In all these countries the dollar acceptance, and "dollar exchange," for which four years ago we modestly and prayerfully entreated a kind consideration, through force of circumstance have now been brought to a leading position. There are outstanding to-day, drawn in almost every part of the globe, approximately $500,000,000 in American bankers' acceptances. But this is only the beginning. Some months ago I ventured the prediction that in the not too distant future we should see American bankers' acceptances reach the billion-dollar mark, and I have no hesitation in reaffirming that opinion.

The growth of the American bankers' acceptance business is likely to continue so fast that fear is expressed by some lest our available acceptance facilities may soon prove inadequate. It has been urged, therefore, that the limitations, placed by the Federal Reserve Act upon member banks of the Federal Reserve System, should be widened so as to enable these members to accept to a larger extent than the 100 per cent to 150 per cent of their capital and surplus, up to which limit they may accept under existing law. My own view is that we should be very careful not to impose an excessive load of liabilities on our large deposit banks. Institutions often having deposits amounting to more than ten times their capital and surplus, and having invested a large portion of these funds in commercial loans involving credit risks, should consider very seriously whether it would be wise for them to add to their existing commitments acceptance liabilities in excess of the present restrictions of the law, unless, indeed, their general deposit liabilities were kept within very conservative limits. It would appear to be the dictate of banking prudence to preserve a certain safe relation between capital and surplus on the one hand and all liabilities, including those for acceptances, on the other.

It was in anticipation of these larger acceptance requirements that in 1916 an amendment was secured by the Federal Reserve Board authorizing national banks to invest in the stock of banks or corporations primarily devoted to the foreign acceptance business. Banks of this new type, under the Federal Reserve Board's regulations, are prohibited from taking demand deposits in the United States, and are required to keep their own resources, as represented by their capital and surplus, in liquid form, as a reserve, as it were, for the protection of their acceptance liabilities. In that case, it was held, it would be a conservative and logical policy to permit these institutions to have outstanding acceptances plus deposit liabilities equal to a liberal multiple of their capital and surplus.

If, as I hope, the demand for American acceptance credits should continue to grow, the creation of additional acceptance banks or corporations would best meet the situation. Under the present rulings of the Federal Reserve Board, an additional $50,000,000 invested in acceptance corporations would easily provide further acceptance credits in excess of $300,000,000.

It is not, however, in foreign acceptances alone that bankers' acceptances will occupy a prominent place. The domestic bankers' acceptance, though not of equal portent, is also destined to play a rôle of great importance. Domestic bankers' acceptances may be made for two purposes: first, to finance domestic shipments of goods, and second, to carry staples, provided that in the latter case the acceptor is secured by warehouse receipts (or similar documents) conveying title to standardized non-perishable staples having a wide market. The effective use of the domestic bankers' acceptance is largely predicated upon the proper development of modern and safe warehousing facilities.

Domestic acceptances are most important as equalizers of money rates all over the country. It will be easy for you to grasp the great economic service they can render in this respect if, as an illustration, you bear in mind how, during the cotton crop season, acceptances made by strong southern firms, and secured by properly safeguarded warehouse receipts issued by warehouses independent of the borrower, would readily find their way into other districts either through the intermediary of the Federal reserve banks or through banks, dealers, or discount companies. They would thus relieve financial pressure in sections where seasonal demands might otherwise be heavy. Moreover, if acceptance facilities in such sections should become exhausted, banks in other districts could readily accept against these warehouse receipts, provided the latter are issued by warehouses responsible beyond doubt, and surrounded by proper safeguards.

Great headway has been made during the last year in developing a freer market for acceptances; the banks have reached a much better understanding of the proper principles to be observed in this respect. The pernicious habit, originally practised, whereby the accepting bank held its own acceptances, has generally been abandoned, and to-day acceptances are being placed in a larger measure through dealers, other banks, or discount corporations.

This short sketch can give you only a very meager outline of what has been achieved in American acceptance banking during these last four years; it is meant to stimulate your interest rather than to satisfy it with respect to the vast possibilities the future has in store both for the banker and the business man.

To point to the things to be done is, however, only one side of the Acceptance Council's functions: of equal importance is its duty to emphasize the things not to be done.

In this connection, I am reminded of a story I once heard concerning a man belonging to a species now soon to be extinct and to be found by our children in Webster's dictionary only, the "bartender." A man of this profession, in prehistoric times, when about to leave his position was turning over the cash-register to his successor. "Please show me how it works," said the newcomer. "I will show you how it works," said the other, "but I won't show you how to work it."

The inference is clear. Those of us who have helped in paving the way for the Federal Reserve Act and tried to formulate amendments for the purpose of enlarging the Act from time to time—so as to keep it wide enough to meet the country's continuously growing requirements—know how impossible it is to write banking laws tight enough to prevent abuses without at the same time crippling highly useful powers, absolutely essential, indeed, if we are to compete in world markets with nations entirely free from legislative fetters. In these countries—I am thinking of England particularly—it is sound banking sense and conservative business prudence that constitute the unwritten, but none the less very effective, law, and it should be our endeavor to follow their example. We must have laws leaving some latitude; but within this latitude we must establish our own sound business usages that effectively prevent unwise abuses.

With respect to bankers' acceptances, permit me to give you just a few illustrations: It is clear that the Federal Reserve Act when authorizing domestic acceptances contemplated two kinds of credits: one—acceptances secured by readily marketable staples, but not to be secured by any other kind of goods, and two—credits to finance the transportation of any kind of goods. In both cases the law prescribes that documents—warehouse receipts or bills of lading, respectively—are to be attached when the acceptance is made. Power, however, is given to accepting banks to release documents in order to facilitate the handling of the goods. But you can readily see that abuse is possible by presenting documents at the time the acceptance is made and using these documents over again, after release, to secure another credit. You can easily imagine, moreover, how under the guise of financing a domestic transaction lasting only a week or two, a 90-day credit might be secured, which thus might serve to carry articles other than readily marketable staples. It is evident, furthermore, how easily, by this method, these acceptances may be turned into unsecured transactions; and unsecured credits amounting in the aggregate to 20 per cent of the capital and surplus of a bank may thus be granted to one single party instead of 10 per cent provided as the limit for similar loans under the National Bank Act. Should the law be amended so as to prevent such abuses, or should the Federal reserve banks and the accepting banks get together and adopt measures to stop bad practices of their own accord? I do not think there can be any doubt as to which would be the better course.

Irrespective of what our laws permit or prevent, and without attempting to formulate too technical or too scientific a rule, or presuming to give any but my own personal views of the matter, we may, I believe, enunciate these principles as generally recognized sound banking ethics.

These principles should not be understood, however, as applying to trade acceptances, or single-name notes, which are instruments of entirely different character.

A trade acceptance is the obligation of a purchaser to pay to the seller the price of goods bought; it represents, as it were, a loan of goods.

The loan on single-name paper might be held generally to represent a loan of cash; while the bankers' acceptance is to be considered as a loan of credit. The bank granting an acceptance credit is not expected to advance cash; the customer is enabled to secure cash on the strength of the bank's credit by the sale of the acceptance in the domestic market, or abroad as "exchange," and he is under contract to put the accepting bank in funds in ample time before the acceptance matures. No cash outlay on the part of the acceptor is thus involved.

As compensation, the acceptor receives a commission commensurate with the length of the credit period and the risk involved.

Bankers' acceptances ought never to be used in order to finance permanent investments, or for the purpose of furnishing working capital, or for providing funds for speculation in securities, staples, or other articles.

Bankers' acceptances are primarily designed to finance goods in course of transportation and in their various stages from origin to final distribution.

Staples in warehouses may properly be considered as constituting a temporary stage between production and distribution (but it is a dictate of banking prudence that such staples, to be the basis of domestic acceptances, either be under a contract of, or awaiting reasonably immediate, sale or delivery into the process of manufacture, and that they never be carried as a pure speculation).

Goods in course of production in foreign countries under a definite contract for subsequent transportation may be considered as offering a legitimate basis for bankers' acceptances, even though the products may not yet be ready for shipment when the bill is drawn.

But care should be taken in all these cases that the proceeds of the goods will liquidate the credit if the sale of the goods takes place before maturity of the acceptance.

A reasonable number of renewals of acceptances is legitimate if, for good and valid reasons, disposal of the goods cannot be completed within the period of the first credit.

Where documents are released, the title to the goods, where-ever possible, should be preserved; in any case a moral hold, if no other, ought to be maintained to this extent at least that, before the acceptor is paid, title to the goods should not pass into the hands of other creditors, and if the goods are sold the proceeds should be applied to paying off the acceptor.

Bankers' acceptances drawn in certain foreign countries for the purpose of furnishing dollar exchange are justified where they are to be considered as anticipations of drafts expected to be drawn within a reasonable time for the purpose of the transportation of goods in course of production (e. g., crops). The law provides that they may be drawn for the purpose of "furnishing exchange" in countries where the customary means of remittance is the 90-day bankers' acceptance.

Bankers' acceptances ought to show by some reference on the face of the bill the nature of the transaction financed, as in England, where the bill generally refers to invoices, letters of credit, or bills of lading, as the case may be.

Acceptance risks ought to be properly distributed; it is bad banking to grant too large an acceptance credit to any single party, no matter how good its standing.

It is bad banking to grant unduly large acceptance credits on any single kind of collateral.

Bankers' acceptance credits ought to be taken only from banks and bankers of undoubted standing and of national reputation (and in the case of foreign drafts, of international reputation).

Acceptances ought to be made and sold for the benefit of the drawer, not for the accommodation of the acceptor.

The acceptance business, in many respects, is similar to insurance business. There must be a proper appreciation and a wise distribution of the risks involved. There must be a premium corresponding to the risk, and a recognition on the part of the insured that he is taking a serious chance in dealing with companies that are weak or disregard sound business rules.

These are illustrations of principles that I believe the business and banking communities ought clearly to recognize, firmly establish, and enforce. There is no doubt about their ability to do so if the Federal reserve banks, under the guidance of the Federal Reserve Board, coöperate. The power vested in the Federal Reserve Board to declare acceptances eligible or ineligible for purchase or rediscount by the Federal reserve banks gives them a practically unlimited control over the practices to be encouraged or permitted in the development of the usages of granting, drawing, and selling bankers' acceptances.

The field is new, however, and still unexplored in many corners. Unanimity as to the soundest principles and habits does not yet exist. Our problems will require certain adaptations of European practices to our own needs, and the best methods will have to be developed by careful study and common counsel.

The American Acceptance Council hopes to be able to do its full share in this work. It has established a relationship of close coöperation with a committee appointed by the Federal Reserve Board tilling the same ground. Together we hope to bring about a clearer understanding of the necessities of the case, to ascertain the best banking opinion, and then to make recommendations with respect to principles to be observed, usages to be adopted, rulings to be made, and, if required, legislation to be enacted.

The sounder and the more effectual the unwritten law of good practices adopted and enforced by common consent, the less the necessity for the Federal Reserve Board or Congress to regulate business by rigid laws and rules.

In closing, I should like to suggest to you a thought closely related to this question of wise or unwise use of credit and very much in my mind.

It has occured to you, no doubt, how intimately connected at this time is the question of government financing and thrift with the problem of interest rates, safe banking, and credit. Every substantial citizen of the Union has become the owner of government bonds, and contributes, somehow or other, to the gigantic funds flowing into the Treasury in the form of direct or indirect taxation. No one can escape the most inexorable form of taxation to which to-day almost every country is subjected in the form of inflated prices.

We all realize the determining influence that individual thrift will exercise in readjusting present abnormal conditions; individual economy must make up for the vast, and in war times unavoidable, waste of the government. But it is gradually becoming clearer and clearer to the country that now, at the end of the War, individual thrift must be accompanied by economy on the part of the government, and this leads to a growing recognition on the part of many that the financial methods of our government must undergo a thorough reform and reorganization.

A body of expert credit men, such as this, understands more clearly than any other group of men what the lack of system in budgeting, accounting, and auditing has meant in the past, and what benefits proper and advanced methods may secure for us in the future.

How much credit would you grant to a department store that left it to each chief of a section, or even a sub-section, to enter into commitments obligating the corporation without any knowledge of what expenditures are being undertaken in other parts of the business, and without any single officer in the whole organization being conversant with the total commitments undertaken, or the revenues available to meet the obligations incurred?

How much credit would you grant to such a department store if you knew that only by the joint action of two officers could payments be authorized, but that it was possible for one of them to close shop and go home without first having provided for the proper financing of the business? Or if you knew that one department could be prevented from securing most essential articles unless some salesman, entirely disconnected with the particular transaction, could secure favorable consideration for some particular transaction in which his own customers or friends at home were interested?

That, substantially, is the condition of the United States. In the past the "department store" was in a state of such affluence that it did not seriously matter what each chief of a section committed himself to, or how extravagant he was. With a Federal budget, however, that now has reached unprecedented figures, and with the tremendous burden of taxation now resting upon the country, I believe that the time has come when the adoption of a national budget system is felt by all as a necessary reform to be undertaken without delay. We should have a *permanent* staff or board, whose business it would be to examine and coördinate the estimated income and expenditures of all departments and bureaus, to pare down, without fear or favor, whatever is unessential so as to bring the expenditures within the scope of what reasonably we may expect to be able to raise, and, finally, to oppose extravagance, no matter what political influence it might subserve. We need a non-partisan group of fair-minded and independent men constituting an element of continuity and expert knowledge, at the service of every new administration facing the intricate problems of taxation, amortization, and governmental borrowing.

I believe it would be most timely for this convention of credit men to devote its attention to this question of a national budget system. The keen interest taken in it by many prominent leaders in Congress makes us hope that it will be taken up in the near future. Both parties, as a matter of fact, stand committed to it. The danger, however, is that those influences in Congress, that have profited from the vicious practices of the past, will bend their efforts to emasculate any thorough legislation and to give us a budget system in name only, but not in substance. It is most important, therefore, that a group of men as here assembled, reaching all parts of the country, should fully grasp the intricacies of the problem, that it should place itself behind the movement and see to it that those representing them will hear, in no uncertain manner, what are the earnest wishes of the people.

Greater economy in our financial administration is necessary in order to bring about a proper readjustment of prices and to bring back to a more normal scope taxation, which now endangers the further development of the country.

Our future as world bankers offers opportunities which baffle the imagination. The grasping of these opportunities may mean relief to a large portion of suffering mankind, but these opportunities are so large that even our phenomenal banking strength may sooner or later threaten to become exhausted unless scientific economy is practised from top to bottom. Even the strongest is weak if he does not husband, or over-estimates, his strength!

NOVEMBER 4, 1919

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AMSTERDAM ECONOMIC CONFERENCE OCTOBER 13–14, 1919

IN the summer of 1919 I visited Europe for the first time since the outbreak of the War. My friend, Dr. G. Vissering, President of De Nederlandsche Bank, of Amsterdam, invited me to attend a conference to be held at Amsterdam, at which a small number of economists and financiers were to discuss the economic and financial dangers overhanging Europe as a consequence of the conditions created by the War and the Peace Treaty. I accepted and the meeting took place on October 13th—14th, 1919. The following gentlemen participated: Dr. G. Vissering; Mr. Joost Van Vollenhoven, Vice Governor of De Nederlandsche Bank; Mr. E. C. Ter Meulen, of Hope & Co., of Amsterdam; Mr. John Maynard Keynes, of Cambridge (England); Senator Georges-Raphael Lévy, of Paris; Mr. F. I. Kent, of New York (taking the place of Governor Benjamin Strong), and myself.

Several proposals how to steady the tottering exchanges were discussed. Agreement finally prevailed, however, that it would be futile to attempt to tamper with the exchanges, that their disorganization was the inevitable result of underlying conditions, and that nothing could be done to improve the situation unless the world was first helped to see things in their real light. It was decided that an effort should be made to have leaders of thought of the principal countries unite in a public appeal arousing world opinion to a return to reason.

Mr. Keynes and I, as a sub-committee, were charged with the difficult task of drawing up such a memorandum. We submitted it the next day and the Conference adopted it with slight modifications. The memorial was then laid before a conference of Swiss, Danish, Swedish, and Norwegian bankers who gave it their endorsement (November 2nd—3rd). This conference was to launch the memorandum with as impressive an international endorsement as could be mustered. The first half of the memorandum had been writtem by me, the second half by Mr. Keynes and Mr. Robert Brand, of London (who had been prevented from being present but later on collaborated with Mr. Keynes). Leading citizens in England, France, Denmark, Sweden, Norway, and Switzerland agreed to sign the statement. Meanwhile, I had returned to the United States in order to secure signatures here. A statement I gave to the press upon my return by the end of October is printed below. Prominent American citizens readily accepted the invitation to join. On the other hand official Washington created difficulties. The Senate was then still struggling with the Versailles Treaty, and it was feared in administration circles that the proposed appeal was likely to add fuel to the flames. It became necessary to eliminate and modify certain passages in the American version of the memorandum, which is printed below with footnotes indicating the discrepancies between the European and American forms.

The publication of the memorandum on January 15th and 16th, 1920, created quite a stir all over the world. One may safely say that ultimately the first Brussels conference resulted largely from this first movement. The resolutions passed later on by the Brussels conference reiterated, verbatim in many passages, the views expressed in the Amsterdam memorandum. From Brussels the road led to Genoa, London, and ultimately to the Dawes Plan.

My press statement of November 4th, 1919, read as follows:

One cannot spend two months in Europe without being deeply impressed with the fact that War has opened wide the dykes once protecting our old form of society and that the unloosened currents, still uncontrolled, are raging over areas far beyond the boundaries of the countries directly involved in the War. Nobody can foretell at this time what the world's picture will be when ultimately the floods will subside. How far it will remain submerged or be able to emerge will not be the result, however, of an automatic process. As it was the will of men that broke the dykes—dykes, it is true, that had grown too weak and attempted to constrain gigantic forces within too narrow a compound—so it will be the will of men that will determine the final outcome. The lesson that one brings home from Europe is, therefore, that we must not stand by idly with folded hands while the world is drowning; but that it is our duty, and within our power, to arrest a movement which if unchecked and permitted to run into extremes, will engulf us all.

There are many who, disgusted and disheartened, believe that we, in the United States of America, should wash our hands of Europe and leave it to her to straighten out her own affairs. It is too late for that. By the decisive part we played in concluding the war and the peace we have assumed a moral responsibility which we now cannot shirk, and even were we inclined to do so we could no more free ourselves from the meshes that now link us to Europe. For the future course of the world will be influenced very materially by economic forces, and these forces we largely control as, inversely, to a certain extent they control us. In order to survive, Europe needs our products and requires them largely on credit, and it is our moral duty to furnish these goods. While our self-interest is involved, Europe's dilemma is so much more acute than ours that it places in our hands the key to the situation, but at the same time the responsibility of using it wisely.

The present problem is not a simple one; it is the upshot of many influences and conditions varying in degree in the several countries affected; but there are two fundamental evils common to all which must be eradicated if world bankruptcy or communism is to be avoided. These are the continuous "increase of prices" and "decrease of production." "Prices" must continue to rise as long as the leading countries spend every year billions more than they collect from taxation and other regular revenues, covering the resulting deficiencies by issuing additional currency, treasury bills, or other government obligations. As long as this "watering process" is indulged in, the value of capital must further decline and, if persisted in long enough, it must end in something like the Russian or Austro-Hungarian conditions, where the savings of the past invested in money and funded securities have been practically wiped out.

While to some extent the present labor unrest is "psychological" and in certain aspects, as far as it disregards the public interest, may be considered destructive and immoral, there cannot be any doubt that as long as the rise in prices continues, labor will have to fight for and be entitled to increased wages. On the other hand, it is obvious that a higher scale of wages is in itself a factor making for a further increase in prices. This unfortunate reaction cannot be avoided until the prime driving force has been eliminated, which is the persistent depreciation of capital by the continuous issue of government securities and currency for the purpose of covering deficiencies caused by excess current expenditures.

Prolonged disregard of sound economic principles will wreck business enterprise as well as governments. To issue government obligations or currency for the purpose of paying idle men, or for providing below cost such things as transportation or food, or for covering extravagant military or other expenditures, is an insane business practice that sooner or later must lead to the ruin or bankruptcy of every country indulging in such methods. To the extent that expenditures cannot be reduced receipts from taxation must be increased.

It is easier for the United States to place its budget on a sound basis than for any other of the leading Powers involved in the War. Our responsibility in this respect is a heavy one and demands, not only that we establish model conditions for ourselves, but also that we insist that sound principles be adopted by countries requiring our financial support. Unless we work toward this end the increase of prices cannot be arrested and, moreover, we would be acquiring the obligations of debtors headed for insolvency. Our responsibility goes even further than that. Of all the lending countries we are the only one that, for the time being, has an open gold market, where the relation between gold on the one hand and goods and services on the other can establish itself on a fairly natural basis. No other country, therefore, will play as decisive a rôle in determining the future level of prices as we.

A great deal is being said about the necessity of stabilizing foreign exchange. To my mind it is futile to attempt to tinker with this problem of stabilizing the level of these various foreign reservoirs and to establish their definite relations to one another and to the dollar, which will be the pivot of all, until the leaks have been stopped, and that is not possible so long as the government printing presses work overtime manufacturing new money and government obligations. When once this baneful process is arrested, discount rates may again become powerful influences in bringing about deflation. Until budgets are properly balanced discount rates, however, are powerless in this respect.

The pre-war level of prices has gone for good and ever. Somehow we had to pay for the waste and expenses of the War, and if the future price level should establish itself at 100 per cent higher than that prevailing before the War, that would mean that the savings of the past through this watering process have been cut in two and that to that extent they have been consumed in order to pay for the War. Whether the destruction of capital has gone that far or how much further it will proceed will depend upon the steps that we shall now take to arrest it. The longer we wait the greater will be the loss.

While the proper balancing of the budgets must, therefore, be the first step, without which the world cannot rid itself of its present predicament, this measure, in order to bring relief, must be accompanied by others. Everybody knows that in order to prevent a further rise of prices it is necessary that production be increased and consumption be decreased. The necessity of such a course has been forcefully urged by many, it is conceded by all—and practised by nobody.

In Europe and in the United States there never was greater recklessness in spending money than there has been prevailing since the conclusion of the Armistice. The ease with which a larger amount of depreciated money can be earned has diminished the respect for money and the eagerness to save. A willingness to subordinate or sacrifice one's wishes and pleasures to the greater advantage of the country, splendidly manifested during the years of the War, has ended in the present reaction—of an orgy of brazen self-indulgence at the very moment when the war bill is presented for payment.

Labor suffers from insufficient wages, capital is being decimated, and the middle classes, practically wiped out, are viewing the future with deep despair. And all of this for the reason that for five years the world has destroyed and consumed more than it produced and has not yet been aroused to the realization that the longer it persists in remaining in this foolish and fatal condition the more terrible will be the chaos and the suffering for which we are headed. This is a world state of mind, based with some on cynic frivolity, with others on scorn and exasperation or deep disappointment over the failure of human society.

In these circumstances may we hope to be able to persuade the workingman that while his striving for adequate adjustments of wages is generally recognized as legitimate, and while honest efforts are made in almost all countries of the world to comply with his just demand for a reasonable representation and coöperation in the management of his employer's affairs, any tendency on his part to reduce production is nothing short of a crime against the very society of which he is a part? May we hope to convince the reckless consumer that his guilt is as heavy as that of the slacking producer—except by necessity, the only taskmaster whose authority will still be respected?

Only when the world ceases covering deficits by printing new money and obligations, only when a greater scarcity of money can assert its influence, will excessive consumption be brought under control, and will there be called into play a consequent greater supply of labor and a greater willingness to work. This presupposes, however, that terrorism will not be permitted to threaten those willing to work.

It is interesting to watch the various ways in which labor problems are being studied and approached in Europe. "Over there" they look to the United States to take the lead in solving the question. Pre-war labor conditions with us having been far better than abroad and our men having enjoyed full political liberty and a free road to the top of the ladder in practically every enterprise, it is believed that we should find less difficulty in this respect than any other country.

In Europe it is believed that our Senate does not fully realize the gravity of the situation. Friends and enemies condemn many features of the Peace Treaty. But all agree—even the Germans, who more than any other nation deplore some of the terms—that nothing could be more fatal than to prolong the present uncertainty; that the treaty must now go into effect and that when once a foundation, even though a defective one, has been laid we can begin successfully to combat the baneful forces that now threaten the whole world. In this work the United States cannot be missed. Europe counts on our influence, not only in solving the economic problems involved, but also in straightening out the League of Nations (which in its present form is disappointing to independent minds in all countries) and through it some of the inequalities that now mar the instrument.

The Reparation Commission, as a first step, will have to clarify the situation by studying and determining the limit of the burden to be imposed upon Germany, a burden which may not exceed her maximum power of taxation, if bankruptcy is to be avoided. The power to make or break Germany lies thus in the hands of the Reparation Commission, and the United States cannot shirk the duty of coöperating in reaching a wise conclusion, upon which will depend not only the fate of that country but also that of her main creditors—who, in turn, are our debtors. That, however, opens a chapter which it would lead too far to discuss at this time.

The first thing to be done is—as a prominent British financier put it—"to deflate our ideas." The world lives in a fool's paradise based upon fictitious wealth, rash promises, and mad illusions. The disease is world-wide, it has spread too far to enable us to deal with it as a whole. We may agree on the principles on which it must be fought, but each country will have to be treated in accordance with its own particular conditions. The first step, however, is to prick the bubbles of false premises and to begin by clearing the world balance sheet of fictitious assets as far and as fast as we can. As the situation will thereby gain clarity and simplicity we shall grow in strength and competence to deal with whatever difficulties remain to be overcome.

An International Appeal

The Amsterdam memorandum[1] reads as follows:

The undersigned individuals beg leave to lay before their Government a proposal that the Governments of the countries chiefly concerned, which should include the United States, the United Kingdom and the British Dominions, France, Belgium, Italy, Japan, Germany, Austria, the Neutral countries of Europe, and the chief exporting countries of South America, should be invited forthwith (the matter being of the greatest

[1] Regarding United States, see note on page 656.

urgency) to convene a meeting of financial representatives, for the purpose of examining the situation, briefly set forth below, and to recommend, in the event of their deciding that coöperative assistance is necessary and advisable, to whom and by whom assistance should be given, and on what general conditions.

They venture to add to the above recommendation the following observations:

The War has left to conqueror and conquered alike the problem of finding means effectively to arrest and counteract the continuous growth in the volume of outstanding money and of Government obligations, and, its concomitant, the constant increase of prices. A decrease of excessive consumption and an increase of production and taxation are recognized as the most hopeful—if not the only—remedies. *Unless they are promptly applied, the depreciation of money, it is to be feared, will continue, wiping out the savings of the past and leading to a gradual but persistent spreading of bankruptcy and anarchy in Europe.*

There can be no social or economic future for any country, which adopts a permanent policy of meeting its current expenditure by a continuous inflation of its circulation and by increasing its interest-bearing debts without a corresponding increase of its tangible assets. In practice every country will have to be treated after careful study and with due regard to its individual conditions and requirements. No country, however, is deserving of credit, nor can it be considered a solvent debtor, whose obligations we may treat as items of actual value in formulating our plans for the future, that will not or cannot bring its current expenditure within the compass of its receipts from taxation and other regular income. This principle must be clearly brought home to the peoples of all countries; for it will be impossible otherwise to arouse them from a dream of false hopes and illusions to the recognition of hard facts.

It is evident that Germany and Austria will have to bear a heavier load than their conquerors, and that, in conformity with the Treaty of Peace, they must bear the largest possible burden they may safely assume. But care will have to be taken that this burden does not exceed the measure of the highest practicable taxation, and that it does not destroy the power of production, which forms the very source of effective taxation. For the sake of their creditors and for the sake of the world, whose future social and economic development is involved, Germany and Austria must not be rendered bankrupt. If, for instance upon close examination, the *Commission des Réparations* finds that, even with the most drastic plan of taxation of property, income, trade, and consumption, the sums that these countries will be able to contribute immediately towards the current expenses of their creditors will not reach the obligations now stipulated, then the Commission might be expected to take the view that the scope of the annual contributions must be brought within the limits where solvency can be preserved, even though it might be necessary for that purpose to extend the period of instalments. The load of the burden and the period during which it is to be borne, must not, however, exceed certain bounds; it must not bring about so drastic a lowering of the standard of living that a willingness to pay a just debt is converted into a spirit of despair and revolt.

It is also true that amongst the victorious countries there are some whose economic condition is exceedingly grave, and which have reached the limits of their taxing powers. It appears therefore to the undersigned, that the position of these countries, too, should be examined from the same point of view of keeping taxation within the power of endurance, and within a scope that will not be conducive to financial chaos and social unrest.

The world's balance of indebtedness [1] has been upset and

[1] In America the paragraph beginning with the words: "The world's balance of indebtedness" and winding up with the words: "towards a cure?" has been left out.

has become topheavy and onesided. Is it not necessary to free the world's balance sheet from some of the fictitious items which now inflate it and lead to fear or despair on the part of some, and to recklessness on the part of others? Would not a deflation of the world's balance sheet be the first step towards a cure?

When once the expenditure of the various European countries has been brought within their taxable capacity (which should be a first condition of granting them further assistance), and when the burdens of indebtedness, as between the different nations, have been brought within the limits of endurance, the problem arises as to how these countries are to be furnished with the working capital necessary for them to purchase the imports required for re-starting the circle of exchange, to restore their productivity, and to reorganize their currencies.

The signatories submit that, while much can be done through normal banking channels, the working capital needed is too large in amount and is required too quickly for such channels to be adequate. They are of the opinion, therefore, that a more comprehensive scheme is necessary. It is not a question of affording aid only to a single country, or even to a single group of countries which were allied in the War. The interests of the whole of Europe and indeed of the whole world are at stake.

It is not our intention to suggest in detail the method by which such international coöperation in the grant of credit may be secured. But we allow ourselves the following observations:

1. The greater part of the funds must necessarily be supplied by those countries where the trade balance and the exchanges are favorable.

2. Long-term foreign credit, such as is here contemplated, is only desirable in so far as it is absolutely necessary to restore productive processes. It is not a substitute for those efforts and sacrifices on the part of each country, by which alone they can solve their internal problem. It is only by the

real economic conditions pressing severely, as they must, on the individual that equilibrium can be restored.

3. For this reason, and also because of the great demands on capital for their own internal purposes in the lending countries themselves, the credit supplied should be reduced to the minimum absolutely necessary.

4. Assistance should as far as possible be given in a form which leaves national and international trade free from the restrictive control of Governments.

5. Any scheme should encourage to the greatest extent possible the supply of credit and the development of trade through normal channels.

6. In so far as it proves possible to issue loans to the public in the lending countries, these loans must be on such terms as will attract the real savings of the individual; otherwise inflation would be increased.

7. The borrowing countries would have to provide the best obtainable security. For this purpose it should be agreed that:

a. Such loans should rank in front of all other indebtedness whatsoever, whether internal debt, reparation payments, or interallied governmental debt.

b. Special security should be set aside by the borrowing countries as a guarantee for the payment of interest and amortization, the character of such security varying perhaps from country to country, but including in the case of Germany and the new States the assignment of import and export duties payable on a gold basis, and in the case of States entitled to receipts from Germany, a first charge on such receipts.

The outlook at present is dark. No greater task is before us now, than to devise means by which some measure of hopefulness will reënter the minds of the masses. The reëstablishment of a willingness to work and to save, of incentives to the highest individual effort, and of opportunities for every one to enjoy a reasonable share of the fruit of his exertions must be the aim towards which the best minds in all countries should coöperate. Only if we recognize that the time has now come when all countries must help one another, can we hope to bring about an atmosphere, in which we can look forward to the restoration of normal conditions and to the end of our present evils.

In conclusion the signatories desire to reiterate their conviction as to the very grave urgency of these questions in point of time. Every month which passes will aggravate the problem and render its eventual solution increasingly difficult. All the information at their disposal convinces them that very critical days for Europe are now imminent and that no time must be lost if catastrophes are to be averted.

In the various countries the signatories to the memorandum have been the following persons:

America (United States of)

William H. Taft, *Former President of the United States.*

Elihu Root, *Former Secretary of State, and ex-Senator.*

Herbert Hoover, *Former Director U. S. Food Administration.*

Myron T. Herrick, *Former Ambassador to France.*

Harry A. Wheeler, *Former President United States Chamber of Commerce, and Chairman International Trade Conference of U. S. Chamber of Commerce.*

Alfred E. Marling, *President New York Chamber of Commerce.*

William Fellowes Morgan, *President New York Merchants' Association.*

Frank A. Vanderlip, *Chairman Banking Committee New York Chamber of Commerce.*

Paul M. Warburg, *Chairman Acceptance Council and Committee on Banking of New York Merchants' Association, and former Vice Governor Federal Reserve Board.*

R. S. Hawes, *President American Bankers Association.*

James A. Stillman, *President National City Bank of New York.*

A. Barton Hepburn, *Chairman Chase National Bank, New York.*

CHARLES H. SABIN, *President Guaranty Trust Co., New York.*
L. L. RUE, *President Philadelphia National Bank.*
JAMES B. FORGAN, *President First National Bank, Chicago.*
FESTUS J. WADE, *President Mercantile Trust Company, St. Louis.*
F. O. WATTS, *President Third National Bank, St. Louis.*
JOHN SHERWIN, *President First National Bank, Cleveland.*
A. W. MELLON, *President Mellon National Bank, Pittsburgh.*
EMORY W. CLARK, *President First and Old Detroit National Bank.*
FREDERICK H. RAWSON, *President Union Trust Co., Chicago.*
R. G. RHETT, *President People's National Bank, Charlestown, South Carolina.*
H. DODGE, *Partner Phelps Dodge Corporation, New York.*
DARWIN P. KINGSLEY, *President New York Life Insurance Co.*
CHARLES W. ELIOT, *President Emeritus Harvard University.*
ARTHUR T. HADLEY, *President Yale University.*
H. P. JUDSON, *President University of Chicago.*
EDWIN A. ALDERMAN, *President University of Virginia.*
EDWIN R. A. SELIGMAN, *Professor Economics, Columbia University.*
F. W. TAUSSIG, *Professor Economics, Harvard University.*
SAMUEL REA, *President Pennsylvania Railroad Co.*
LOUIS W. HILL, *Chairman Great Northern Railroad Co.*
DANIEL WILLARD, *President Baltimore and Ohio Railroad Co.*
GEORGE H. MCFADDEN, *Partner G. H. McFadden & Brother, Philadelphia.*
JULIUS H. BARNES, *Partner Barnes Ames Co., and Director U. S. Grain Corporation.*
JOHN G. SHEDD, *President Marshall Field Company, Chicago.*
JACOB H. SCHIFF, *Partner Kuhn Loeb & Co., New York.*
GEORGE M. REYNOLDS, *Chairman Continental and Commercial National Bank, Chicago.*
ROBERT L. BROOKINGS, *President Board Trustees, Washington University, St. Louis.*
A. L. MILLS, *President First National Bank, Portland, Oregon.*
FRANK B. ANDERSON, *President Bank of California, San Francisco.*

HERBERT FLEISHHACKER, *President Anglo and London Paris National Bank, San Francisco.*

HENRY SUZZALLO, *President University of Washington, Seattle.*

J. P. MORGAN, *Partner of J. P. Morgan and Company, New York.*

Denmark

C. C. ANDERSEN, *Chairman of the Socialist Party in the Landsting (Upper House).*

F. I. BORGBJERG, *Member of the Committee of the social group of the Rigsdag (Parliament).*

I. C. CHRISTENSEN, *Chairman of the Venstre (liberal) Party of the Folketing (Lower House).*

C. C. CLAUSEN, *Chairman of the Merchants' Guild.*

C. M. T. COLD, *Chairman of the Danish Steamship Owners Society.*

A. FOSS, *Chairman of the Board of Industry.*

E. GLUCKSTADT, *Managing Director of the Danske Landmandsbank.*

J. KNUDSEN, *Chairman of the Conservative Party in the Folketing.*

M. MYGDAL, *President of the Board of Agriculture.*

A. TESDORPF, *Member of the Board of Agriculture.*

A. NIELSEN, *Member of the Board of Agriculture.*

J. P. WINTHER, *Managing Director of the Nationalbanken in Copenhagen.*

J. LAURIDSEN, *Managing Director of the Nationalbanken in Copenhagen.*

C. USSING, *Managing Director of the Nationalbanken in Copenhagen.*

M. RUBIN, *Managing Director of the Nationalbanken in Copenhagen.*

W. STEPHENSEN, *Managing Director of the Nationalbanken in Copenhagen.*

J. PEDERSEN, *Chairman of the Venstre Party of the Landsting.*

E. G. PIPER, *Chairman of the Conservative Party of the Landsting.*

C. SLENGERIK, *Chairman of the Radical Venstre Party of the Folketing.*

H. TRIER, *Chairman of the Radical Venstre Party of the Landsting.*

France [1]

Raphael-Georges Lévy, *Economiste, Sénateur.*

Darcy, *Président du Comité des Houillères de France.*

Roger Lehideux, *Président de l'Union Syndicale de Banquiers de Paris et de la province.*

Petit, *Président Tribunal de Commerce.*

Charles Laurent.

De Wendel.

Great Britain

Sir Richard Vassar-Smith. Bart., *Chairman of Lloyds' Bank Ltd.*

Lord Inchcape, G.C.M.G., K.C.S.I., *Chairman of the National Provincial and Union Bank Ltd., and Chairman of the Peninsular and Oriental Steam Navigation Co.*

Walter Leaf, Esq., *Chairman of the London County and Westminster Bank Ltd.*

F. C. Goodenough, Esq., *Chairman of Barclay's Bank Ltd.*

The Right Honourable Reginald McKenna, P.C., *Chairman of the London Joint City and Midland Bank Ltd.*

Sir Robert Kindersley, K.B.E., *Chairman of the National Savings Committee, Director of the Bank of England, Partner of Lazard Bros. & Co. Ltd.*

Sir Charles Addis, *Chairman of the Hongkong and Shanghai Banking Corporation Ltd., Director of the Bank of England.*

Edward C. Grenfell, Esq., *Senior Partner of Messrs. Morgan Grenfell & Co. Ltd., Director of the Bank of England.*

The Honourable Robert H. Brand, C.M.G., *Partner of Lazard Bros. & Co. Ltd., Director of Lloyds' Bank Ltd.*

The Right Honourable Lord Robert Cecil, P.C., K.C.,

[1] The French signatories have prefixed the following reservation to their signatures:

«Il est bien entendu q'un délai raisonnable doit être accordé à chaque pays «pour ramener ses dépenses courantes au niveau de ses recettes provenant des «impôts ou d'autres sources normales de revenus et que les recommandations «sub a. du paragraphe 7 ne peuvent recevoir d'application pour chaque cas «particulier que dans la mesure où elles sont conciliables avec la solidité et «l'ancienneté du crédit des états.»

Formerly Chairman of the Supreme Economic Council of the Allies, Formerly Assistant Secretary of State for Foreign Affairs.

THE RIGHT HONOURABLE H. H. ASQUITH, P.C., *Formerly Prime Minister.*

THE RIGHT HONOURABLE SIR DONALD MACLEAN, K.B.E., *Leader of the Liberal Party in the House of Commons.*

THE RIGHT HONOURABLE J. H. THOMAS, M.P., *Leader of the Labour Party.*

THE RIGHT HONOURABLE J. R. CLYNES, M.P., *Leader of the Labour Party.*

VISCOUNT BRYCE, G.C.V.O., O.M., *Formerly Ambassador to the United States.*

Netherland

DR. G. VISSERING, *President of The Netherlands Bank.*

C. E. TER MEULEN, *Banker, Member of the Firm Hope & Co.*

JOOST VAN VOLLENHOVEN, *Manager of The Netherlands Bank.*

JHR. DR. A. P. C. VAN KARNEBEEK, *Minister of State, President of the Carnegie Foundation.*

J. J. G. BARON VAN VOORST TOT VOORST, *President of the First Chamber of Parliament.*

DR. D. FOCK, *President of the Second Chamber of Parliament.*

JHR. DR. W. H. DE SAVORNIN LOHMAN, *President of the High Court of Justice.*

A. W. F. IDENBURG, *Formerly Minister of Colonies, Governor-General of the Netherlands East Indies.*

S. P. VAN EEGHEN, *President of the Amsterdam Chamber of Commerce.*

E. P. DE MONCHY, RZN., *President of the Rotterdam Chamber of Commerce.*

C. J. K. VAN AALST, *President of the Amsterdam Bankers Association.*

G. H. HINTZEN, *Banker, Member of the Firm R. Mees & Zoonen, Rotterdam.*

F. M. WIBAUT, *Socialist Alderman of Amsterdam.*

G. M. BOISSEVAIN, *Economist.*

E. HELDRING, *Manager of the Royal Netherlands Steamship Company.*

Prof. Dr. G. W. J. Bruins, *Rotterdam.*

Norway

O. B. Halvorsen, *Speaker of Parliament.*

J. Tandberg, *Bishop of Christiania.*

Fridtjof Nansen, *Professor of University of Christiania.*

H. Loeken, *Governor of Christiania.*

B. Holtsmark, *Leader of the Liberal Party.*

G. A. Jahren, *Leader of the Conservative Party.*

J. L. Mowinckel, *Leader of the Radical Party.*

K. Bomhoff, *President Bank of Norway.*

A. Bjercke, *President of the Chamber of Commerce, Christiania.*

A. T. Larsen, Jr., *President of the Union of Norwegian Merchants.*

C. Kierulf, *President of the Union of Norwegian Savings Banks.*

V. Plahte, *President Norwegian Joint Stock Banks Association.*

C. Lütcherath, *President Norwegian Industrial Union.*

Chr. B. Lorentzen, *President Norwegian Exporters Association.*

Joh. H. Aanensen, *President Oversea Exporters & Importers Association.*

T. Fearnly, Jr., *President Norwegian Shipowners Association.*

C. Platou, *President of the Association of Norwegian Manufacturers.*

T. Myrvang, *President Farmers and Smallholders Association.*

P. Volckmar, *President Norske Handelsbank.*

G. Kampstrup Hegge, *Manager Norske Creditbank.*

N. Martens, *Manager Centralbanken for Norge.*

E. Skogstad, *Manager Christiania Bank and Kreditkasse.*

Sweden

J. G. A. Af Jochnick, *President Sveriges Riksbank.*

V. L. Moll, *First Deputy Sveriges Riksbank.*

C. E. Kinander, *President National Debt Office.*

J. S. Son Kjellberg, *President Swedish Bankers Association.*

H. Lagercrantz, *President Swedish Exporters Association, Formerly Minister to United States.*

A. Vennersten, *President Swedish Industrial Association, Formerly Minister of Finance.*

K. A. Wallenberg, *President Chamber of Commerce of Stockholm, Formerly Minister of Foreign Affairs.*

M. Wallenberg, *Manager Stockholms Enskilda Bank.*

O. Rydbeck, *Manager Skandinaviska Kreditaktiebolaget.*

C. Frisk, *Manager Svenska Handelsbanken.*

K. H. Branting, *Member of Parliament, Leader Labor Party.*

Count R. N. Hamilton, *Member of Parliament, Leader Liberal Party.*

S. A. A. Lindman, *Member of Parliament, Leader Conservative Party, Formerly Prime Minister.*

L. H. Kvarnzelius, *Member of Parliament, Leader Liberal Party.*

E. Trygger, *Member of Parliament, Leader Conservative Party, Formerly Member High Court of Appeal.*

K. G. Cassel, *Professor Political Economy.*

D. Davidson, *Professor Political Economy.*

E. F. K. Sommarin, *Professor Political Economy*

Switzerland

G. Ador, *Président Comité International Croix Rouge.*

E. Blumer, *Président Conseil National.*

A. Frey, *Président Union Suisse du Commerce et de l'Industrie.*

R. De Haller, *Vice-Président Direction Générale Banque Nationale.*

J. Hirter, *Président Conseil Banque Nationale.*

Dr. E. Laur, *Secrétaire Union Suisse des Paysans.*

A. Pettavel, *Président Conseil des Etats.*

E. Licot, *Juge Fédéral.*

G. Pictet, *Banquier.*

A. Sarasin, *Président Association Suisse des Banquiers.*

M. Schnyder, *Président Association de la Presse Suisse.*

Dr. H. Tschumi, *Président Union Suisse des Arts et Métiers.*

DECEMBER 4, 1919

XXXI

ADDRESS AT THE FIRST ANNUAL MEETING OF THE AMERICAN ACCEPTANCE COUNCIL

. . . When the Council began its operations the British discount rate for bankers' acceptances stood at about 3½ per cent, and was approximately 1 per cent lower than similar rates prevailing in this country. Many and severe were the critics that insisted that the American private discount rate should be reduced to the English level. In literature published by the Council the opinion was confidently expressed that unless England desired to give up her ambition to again become a leading gold and money center of the world she soon would have to surrender her policy of maintaining artificially low rates of interest and return to a policy of effective discount rates, which, logically, would have to be somewhat higher than ours. Events have since vindicated these views, the British discount rate being at present approximately 1 per cent higher than ours.

The United States being to-day the only free gold market of importance, and the dollar selling at an abnormally high premium in most of the leading financial countries, it is but natural that there should be a world-wide tendency to seek our acceptance facilities for the purpose of financing international commerce. It is obvious that in view of a trade balance so overwhelmingly in our favor it is not only legitimate but our moral duty to grant acceptance facilities in foreign trade to the very limit of our ability, and to organize new corporations for that purpose in case our existing facilities should prove inadequate, provided always that the credits involved are of a sound character and comply with the limitations prescribed by the Federal Reserve Act.

The Council found comparatively little difficulty in establishing a general accord with regard to the broad principles as to what is to be considered a legitimate basis for acceptance credits and as to the best methods and usages to be observed in accepting both in the domestic and foreign trades. As far as the bankers' acceptance is concerned, the Council's main efforts, during the first nine months of its operations, were in the direction of formulating these views and disseminating educational material on these lines.

Greater difficulty has been encountered in trying to develop a common accord with respect to the question of the proper distribution of acceptances, and it is this phase of the problem which will deserve the Council's main attention during the coming year. It is evident that, in the final analysis, our ability to absorb acceptances must govern the volume of the acceptance credits we may be able to extend. It is equally obvious that the popularity of the acceptance, as an investment at home and abroad, will depend upon the reliability of our acceptance market both as to absorbing power and rates. So far the development of our acceptance market has been disappointing. It is true that great headway has been made by the fairly general abandonment of the practice indulged in at first by American acceptors of regularly buying and holding their own acceptances. We may furthermore register as an important step forward the establishment of discount corporations and the growing scope of activity of other firms acting as buyers and distributors of acceptances. But the efforts of these concerns to open up new and reliable channels for the absorption of acceptances and to secure accommodation in sufficient volume and at reasonable cost to permit them to carry their stocks of bills have met so far only with moderate success. Up to the present, the Federal reserve banks, and particularly the Reserve Bank of New York, have been the main market for acceptances. This condition is due to several causes, into some of which it would lead too far to go on this occasion.

In normal times and under an ideal system of banking, bankers' acceptances should form the most desirable and most important asset among the so-called secondary reserves of banks. Up to this juncture, the two most serious obstacles preventing the bankers' acceptance from attaining this position have been the Treasury certificate and the call-loan market.

As long as banks are expected to invest from time to time in large amounts of Treasury certificates, and as long as these certificates are offered on a basis which makes the investment more attractive for the banks than for the small investor (owing to the fact that the government leaves with the banks a substantial portion of the proceeds from the sale of certificates for a considerable time at a low rate of interest and thereby materially increases the return to the banks); as long as it is easier for banks, and at times even more profitable, to borrow against these certificates than to sell bankers' acceptances, so long will the bankers' acceptance have an uphill fight for a proper position in the portfolios of the banks.

When once our Treasury certificates are paid off, or funded, or distributed in a manner to eliminate the banks as their main buyers, and when, as a consequence, our banks become the chief purchasers of bankers' acceptances, we shall enhance most effectively our ability to finance the world's trade and, at the same time, we shall have removed one more element of artificiality in the present financial situation. Like England, where Treasury bills are now being offered on approximately a 6 per cent basis, we shall continue to move in the direction of bringing interest rates under the control of natural forces, a policy without which expansion and inflation cannot be arrested.

While, however, in the question of Treasury certificates we are dealing with a difficulty of a temporary nature which, sooner or later, is likely to be eliminated by the natural course of events, the second obstacle we encounter is of a more permanent character and cannot be removed except through constructive action on our part. We are referring to the system of daily settlements on the stock exchange and the carrying of stock-exchange loans on the "on call" basis.

As long as this system continues, as long as the banks all over the country dump their idle funds upon the stock exchange, treating these stock-exchange loans and New York balances invested therein as their quickest and most important secondary reserve, just so long is the stock exchange in an unsound condition and just so long will it be impossible to secure for our country the benefits of a wide discount market and effective bank rates.

For over ten years some of us have preached the gospel of a system of a centralized reserve banking predicated upon a reliable discount market, as against decentralized banking based upon reserves invested in stock-exchange loans. Only the first part of this program has been carried into effect; the second part still remains to be accomplished. As long as the stock-exchange call loans retain their prominence as secondary reserves of too many banks and as long as stock-exchange demand determines the call-loan rate in the largest money center of the world, we shall not enjoy a complete and perfect banking system. Nobody will deny that for a machine moving as fast and involving as gigantic daily transactions as the New York Stock Exchange a change of system is a most difficult task. It is obvious that it should be undertaken only with the greatest possible precautions. But the difficulty should not scare us into inactivity and indefinite delay when we know that eventually the change has got to be made. When drastic banking reform was first urged the most prominent bankers were opposed to it for the reason that they were prospering under the old system and because they thought that it would be impossible and dangerous to tinker with so immense and, at the same time, so delicate a structure. None the less, the system was remodelled without any serious disturbance, and those were proved to have been right who predicted that if bankers could prosper with an unsafe system they would be certain to enjoy an even greater prosperity with a safe banking system. The same experience is in store for the stock exchange, but the question is: Will the banks of their own free will undertake the task for their own benefit and that of the entire country, or will they delay, as they did until they learned their lesson from the dread experience of the panic of 1907 resulting in governmental legislation?

At present, our gold position is well protected by a trade balance phenomenally in our favor. In the long run, however, our country will not be able safely to accomplish its new task of a world banker without the protection of an effective discount rate regulating a wide discount market.

Our stock exchange must be protected from the vagaries of a daily fluctuating money supply; it should be placed on a basis of weekly or two-weekly settlements. Our bill market, on the other hand, should be protected from the daily "unsettlement" caused by increasing and decreasing demands of the stock exchange. The call money market ought to be based primarily on prime bills that can be quickly turned into cash balances, while the bulk of undigested stocks and bonds ought to be carried by time loans rather than call loans. As a matter of fact, many of these call loans to customers are callable only in name, and, inasmuch as they are carried as a rule indefinitely and actually are not subject to call, they are a source of unrest and danger.

It would be foolish to say that our present financial complexities are due solely to this defect in our system. We could not expect to go through a period of unparalleled destruction and inflation without having to face consequences whose beginnings only we are witnessing to-day. It is possible that in spite of a defective system we may have felt less cramped to-day if since the Armistice we had set our faces more sternly against over-buying, over-spending, and over-speculation, not only on the stock exchange but also in many other trades. It is possible that somewhat higher discount rates would have been less costly to the country than higher prices and a lower level of rates. But these are after all large questions on which opinions may differ. The fact remains that, with the heavy burden which the future no doubt will place upon us, we should be criminally negligent if we left anything undone that would tend to perfect as far as possible every cog in our financial machinery.

The establishment of a world-wide discount market and its emancipation from the evil influences of an unscientifically organized call-loan market is obviously a task still to be accomplished by us. No more useful work could be undertaken by the American Acceptance Council than to center the attention of its members on this problem and to further its solution.

JANUARY 22, 1920

XXXII

FISCAL AND CURRENCY STANDARDS AS THE FUTURE MEASURE OF THE CREDIT OF NATIONS

Address Before Second Pan American Financial Conference, Washington, D.C.

SOME weeks ago I was requested to write an article about American and European banking methods, and when I averred that at present I did not have the necessary time, it was suggested that I revise and bring up to date an earlier essay on the topic written by me about ten years ago. As a matter of curiosity I re-read that earlier contribution with the view of ascertaining what "modern improvements" would have to be added in order to make it serviceable. As you may imagine, I found it as impracticable to revamp the old material as it would have been to use automobile parts of 1908 in manufacturing a modern aeroplane. While the fundamental principles had remained the same, the problems and methods had changed too drastically, with this difference, however, that in contemplating the history of the development of the gas engine, we face a distinct and permanent advance in the art, whereas in studying present banking conditions we are dealing not with progress, but with a form of aberration or disease largely of a temporary character.

While the theory of banking is the same to-day as it was in the past, in practice its most fundamental feature has been almost universally abandoned at this time.

The essential characteristic of ante-bellum banking in leading countries was that their paper circulation and their deposit liabilities were protected by, and therefore kept in a certain relation to, large gold reserves assembled in their central banks.

These central institutions, in turn, could strengthen themselves by drawing on the floating gold supply carried in the pockets of the people and in the vaults of the banks, or by collecting their holdings of other nations' gold obligations.

A gold country repudiating its obligation to pay in gold would have been deemed a bankrupt, and a country permitting the existence of a substantial gold premium, be it domestic or in the form of an excessive discount on its foreign exchanges, would have been considered as being headed for insolvency, a condition which would have caused widespread alarm.

The fear not to be able to fulfill their gold obligations, the wish and will, at all hazards, to ward off any such catastrophe, was the strongest directing force and regulator, not only of the financial, but even of the economic policies of such countries. Rather than expose themselves to the danger of a suspension of gold payments, they would resort to such protective measures as high discount rates, high import duties or taxes, an export premium, borrowing in foreign markets on even onerous terms, or to any other means of counteracting demands caused by an overwhelmingly adverse trade balance.

The War brought about a complete reversal of these doctrines and traditions. The will to win, of necessity, became stronger than the desire to preserve gold standards, and inasmuch as victory was dependent upon ammunition, food, and other supplies, goods became more important than gold, and a policy dictated by the flow of gold was quickly subordinated to a policy directed by the flow of goods. With a greater or smaller degree of promptness and frankness practically the whole world, in one form or another, after having withdrawn gold from circulation, suspended gold payments.

The danger of internal and external gold demands thus eliminated, the protection of high interest rates became unnecessary, and almost all belligerent countries embarked upon an era of government finance based upon low interest rates born of inflation.

This enabled the countries to procure the domestic goods and services needed at a cheap price in terms of money, but at high prices in terms of the goods required—people imagining that they were escaping taxation when, as a matter of fact, they were bearing it in its most drastic and most inexorable form, the depreciation of money.

The controlling and constraining power of gold once removed, there was no limit to inflation as long as any vestige of government credit remained. And on this basis there was, therefore, no limit to the domestic purchasing power of governments, and, consequently, no limit in sight to the rise of prices, once it was well started by precipitate and competitive government buying.

There was no limit to purchasing foreign goods (as far as they could be furnished and shipped and as far as they could not be paid for in services, goods, or securities owned) except the willingness of the foreign seller either to grant individual or government credits in his own currency, or to convert his money into foreign balances or foreign obligations, tempted by the low level of exchanges which naturally followed excessive foreign buying.

When foreign exchanges first began to decline to some point below their normal gold parities, a shiver ran down the spine of the financial community. Bankers and business men predicted that trade would stop and that the end would come if their exchanges were permitted to establish themselves at a substantial discount. But when prices for goods had risen by 100 per cent and more, and when government printing presses, manufacturing a constantly increasing supply of money and credit, were paving the way for further rises, it was difficult to understand why the addition to cost of a few points, as involved in the initial fall of exchanges, should have so far-reaching an effect upon trade. Subsequent events showed, indeed, that the flow of goods, at that stage, was hardly affected by this comparatively moderate increase in cost. The urgent demand for goods had overridden the gold tradition of the past and it overthrew with equal vigor and thoroughness the gospel of the inviolability of the gold parities of exchanges. As a matter of fact, this later development was nothing but a logical sequence; for countries had, in effect, surrendered their exchange parities at the very moment when they suspended gold payments.

It is true that for a while they struggled to preserve the traditional exchange levels. But with gold unavailable and with a shortage of exportable goods, the remaining means of defense could not long protect them. They could try, indeed, to draw money from the seller's country into their own, but that course was rendered difficult through the low money rates generally prevailing in their countries, as a consequence of the process of inflation applied for the purpose of facilitating government financing on easy terms. (Special rates allowed on foreign deposits were not capable of overcoming this obstacle to more than a moderate degree.) They could, furthermore, try to place their own government obligations in the creditor country's markets, payable in the creditor's currency. But that course could give only temporary relief, because the absorbing power for foreign loans, even in normal times, is at best only a limited one. It is even more restricted during a period when the savings of a country are unremittingly drawn upon for the purpose of meeting the home government's requirements, and when—the natural accumulation of investment funds not keeping pace with the government's demands—artificial measures become necessary in order to lead to success these home flotations, while the instruments of inflation are not made directly available for the benefit of foreign governments. In these circumstances, the only remaining avenue to follow was the direct placing of foreign loans with the creditor's government. But when the war emergency had passed, that method became very unpopular where a creditor country was already saturated with its own government bonds, and additional issues involved further inflation of prices and increased annual burdens of taxation.

Under such conditions, where the productive power of a country had been drastically reduced for an extended period, while its heavy demands for foreign goods remained unabated, it was inevitable that after a certain time of grace its foreign exchanges should sink to a heavy discount in countries which with a fairly undisturbed productive power, were still able to furnish the goods. It was natural, however, that governments did not easily surrender to the slaughter of their exchanges. They tried to ward it off because they knew that as long as the decline was moderate and as long as confidence still prevailed in an ultimate return to normal exchange levels, large foreign balances could be attracted as a speculation for a rise, and that these balances, in themselves, would prove important factors in arresting the fall. If this decline exceeded certain bounds, they knew, on the other hand, that distrust would be aroused, causing not only such balances to be withdrawn but opening the door to "bear speculations," resulting in a greater shrinkage than was warranted on strictly economic grounds.[1]

[1] If we place the cost of the War at $220,000,000,000, that would constitute an amount smaller than one-fourth of the estimated ante-bellum worth of belligerent countries. If we included the neutral countries, the proportion would be correspondingly reduced. In the United States it would amount to less than 10 per cent. If we deduct our foreign loans, it would equal less than 5 per cent of the estimated worth of our country.

But let us arbitrarily assume that it was as much as one-fifth of the value of the entire globe, we would have added 20 per cent of "water" to the world balance sheet, while world prices have risen over 100 per cent (and in many countries several times 100 per cent). This extraordinary rise in prices is, therefore, not justified on the mere basis of direct money and credit inflation, but to a large extent it must be attributed to temporary disturbances, including decreased production. If we regain approximately our pre-war power of production, I believe that after a given number of years we shall look back upon our present period as one of excessively high prices for goods and excessively low prices for some rates of foreign exchange in countries expected to survive and to regain social and economic conditions approximating pre-

If to-day we have reached a point where for many countries the old exchange parities have become a myth, have we any reason to be astonished? Is it not much more surprising that we should have expected any other result?

When countries had repudiated their obligation to settle their international gold commitments in gold; when, in doing so, they had shaken off the "strait-jacket" with which the yellow metal had kept under restraint their issues of currency and credit obligations; when, as a consequence, they had increased their government indebtedness in such volume as to make it a very grave and puzzling problem for them to raise the additional revenues necessary to meet the increased interest charges; when government credit thus impaired militated against the placing in foreign markets of some government securities while others, still enjoying a good standing, encountered oversaturated markets because countries squandered their new paper prosperity in lavish extravagance instead of accumulating savings for investment; when, in these circumstances,

war standards. That in many cases exchanges have declined too far may be established from a comparison of the respective cost of production of articles enjoying a world market.

If a Viennese and American factory turned out the same quantity of shoes and could sell them at the same price in Argentina, and if the Viennese factory, owing to the fall of exchange, could be bought for, let us say, half the cost of the American plant, there would be reason to believe that exchange had declined too far. One might ask: Why has not the price for the Austrian factory risen more? The answer is that adjustments of this character naturally take time and that millions of people, who lived on fixed income, are reduced to poverty; that if shoes in Austria rose too far the domestic sale would be too drastically reduced, and the home market is generally more important than the foreign field. Moreover, owing to shortage of raw materials and disorganization of labor, quantities available for immediate export would not be sufficient materially to affect the world market for shoes, or adequately to pay for the masses of materials the country requires at once. These circumstances, together with other abnormal influences, such as prohibitions of certain imports and exports, may in certain cases bring about a temporary depreciation of foreign exchange rates far in excess of what economic conditions would warrant as a permanent basis, unless a country's complete economic collapse is to be expected.

decreased production and increased demand for goods had resulted in a general depreciation of money; when this depreciation varied, however, in the different countries from approximately 100 per cent in one to 1,000 per cent in another;[1] when some countries had fairly well arrested the process of inflation while others were still printing millions of currency and treasury bills to cover their daily deficiencies—what was there that could make us assume that the pre-war dollar was still equal to the pre-war ruble, or mark, or lira, or franc, or sterling? What, in the final analysis, had remained to determine the level of exchanges but the flow of goods, and what remained to control and adjust the flow of goods except the exchange levels?

The discount at which the exchanges of some of the borrowing countries sold in some of the lending countries had to become so marked that it would prove for the borrowing nations not only an effective brake on unnecessary importations and extravagant consumption, but also a stimulus to greater productivity by putting a premium on larger exportations. At the same time, an excessively low exchange rate would ultimately act as a powerful incentive for capital to flow, for temporary or permanent investment, into the markets affected.

With certain reservations, which it would lead too far here to specify, one might say that the premium, or discount, of foreign exchanges represents the differential tending to equalize the discrepancies in the price levels of things between countries of different degrees of inflation, productivity, and credit. This differential is not the cause of the evil, nor the evil itself, as many appear to think—it is a necessary and wholesome factor of adjustment, a partial remedy—though, indeed, a painful one—but not the disease itself.

The belief is entertained by some that, as a solution of our

[1] *The Review of Economics and Statistics* estimates that prices in Italy and France are now 3½ times, in the United Kingdom and Japan 2½ times, and in the United States and Canada over double the respective 1913 average prices.

difficulties, we are likely to abandon gold as the future means of ultimate settlement of international balances. I do not believe that the world will enjoy fairly stable standards of currency and credit until it returns to the observance of approximately the same principles of banking and finance as prevailed before the War.

That does not mean that I foresee that ante-bellum exchange parities will generally be reëstablished. Indeed, I hold the view that quite a number of countries will never regain their previous exchange levels. Their power to reclaim all or in part the shrinkage of their standards will depend upon their ability to produce and to save, and upon the measure of permanent depreciation sustained during the War, not only through a decrease of the value of their property, but also through the increase of their national indebtedness. But whatever the level they may be able to recover, ultimately it will be to their vital interest once more to fasten it to a definite gold relation and to reëstablish a stable exchange, fluctuating between the maxima and minima of gold parities, without which a country's trade and growth will remain subjected to a fatal handicap. (We may expect some countries to aim for a direct return to a free gold standard, while others may have to choose the indirect route of a gold exchange standard.)

But, it is claimed, there may not be gold enough to serve as a basis for the world's financial structure, particularly in view of the phenomenal increase in prices.

Time does not permit to dwell at length upon the question of the future trend of prices and to inquire whether we may not hope, in due course, to witness a substantial recession. Let us bear in mind, however, that the more perfect the machinery of credit, the more insignificant becomes the necessity of settling in actual gold. Where national credit, industrial enterprises, and banking systems are established on a sound basis, adverse balances can be satisfied in many other ways than by payment in actual gold. If government credits and commercial conditions are stabilized, we may confidently undertake the stabilization of exchanges with the existing gold supply. Unless government credits and commercial conditions are stabilized we could not stabilize exchanges even if an additional billion dollars of gold were poured into the world.

And this indicates the road we shall have to follow if we wish to wend our way out of the present labyrinth. We are living in an era where the production of money and credit has increased and the production of goods has decreased. In order to emerge we must produce less credit and money and produce more goods.

In practically all leading countries the people have been urged in the strongest possible manner to produce more and to consume less. I believe it is safe to say that this appeal to voluntary action on the part of the individual has universally failed. Extravagance will not be curbed and the increase in prices will be arrested not by moral suasion, but only through the effective pressure of necessity.

If governments adopt a rigid policy of preventing the further issue of government securities and money for the purpose of covering current deficiencies, they will take the first and most effective step in combating the decrease of production, the rise of prices, and the fall of exchanges. If they will not or cannot adopt such a course, they are headed for insolvency and social and economic disruption.

Where gold payments have been suspended and foreign exchanges have become demoralized, the restraining influence once wielded by gold must be exercised at this stage by rigid budgets. When by curtailing expenditure and by increasing current revenues the issue of government loans to cover current deficiencies has come to a stop, when the floating supply of undigested government securities has gradually been absorbed, the time will again be ripe for an effective control of money markets by the central banks. And when central bank rates are thus once more effective and the foreign credit of a country has been restored, the moment will be at hand when the resumption of gold payments may be considered, and with that the stabilization of foreign exchanges. Whenever that point is reached, a country may be deemed to have completed its economic convalescence. The first step in this direction must be the establishment of honestly balanced budgets.

A country's ability, without additional borrowing, to balance its regular budget, is the test of its solvency. The character of this test at this juncture will decide the measure of its future credit; and upon that, in turn, will largely depend its power to rehabilitate its commerce and trade and its foreign exchanges.

Side by side, however, with the determination of the government to stop the further increase of government debt must go an equally firm policy on the part of the note-issuing banks to arrest a further expansion of circulation.

It was the excessive, though unavoidable, issue of government securities that destroyed the sound understructure of note issues based upon commercial paper and gold. Directly or indirectly, government treasury bills became the main asset of leading central banks, inflating their circulation and crowding into unimportance commercial paper and gold reserves.

As we review this cause and course of the evil, we gain a clear perception of the remedy. As the harm was done primarily through excessive issues of government securities and currencies, so the cure lies in arresting and, if possible, retracing that course. Governments, through a sound budget policy, must stop as fast and as much as possible the increase of their securities and, where a gradual amortization is not practicable, they must in conjunction with the central banks, embark at least upon a policy compelling a distribution of the floating material—of bonds and treasury bills—driving them away from the central and commercial banks into the hands of the investors. This may involve higher levels of interest rates for both commercial paper and treasury bills, but in the long run it would prove a lower price for the country to pay than the undisturbed display of forces making for a continued era of rising prices and social and economic unrest. Unwillingness on the part of central banks further to increase their investments—or their desire, if at all possible, to reduce their holdings—accompanied by curtailment of extravagance on the part of the governments is bound to bring about contraction of loans and a tendency toward falling prices. Moreover, a movement in this direction would be furthered through the increased taxation necessary in order to accomplish the contemplated increase of government revenues.

It is essential, however, that taxation be so devised as to curb extravagance. Our present form of taxation has proved a failure in so far as in a rising market the equivalent of extreme income and profit taxes is being added to the price the public pays for things and in so far as it cripples the investment power of the country and thereby retards its development.

Through the depreciation of the purchasing power of money the value of the return from investments (that is from savings of the past) has been cut in two in countries with the soundest economic conditions, and in those most adversely affected it has been practically wiped out. The distribution of income in all countries has, therefore, been drastically modified. In the aggregate the share of the farmer and of the wage-earner has been phenomenally increased at the expense of those who lived on fixed income from savings of the past. Extravagance must be curbed not only on top, but just as much below for the masses, who receive the bulk of the national income and, in the aggregate, do the largest share of the country's spending. Taxes which, on a rising scale, are laid on spending, not on saving, and effective consumption taxes that make for lower price levels and enrich the government (and not the producer, wholesaler, or retailer), will, I believe, be the logical outcome of sensible and conscientious budgeting.

The world, as a whole has since the beginning of the War, been living in, what business language would term, a "seller's market"; it must be turned into a "buyer's market" if we are to perfect a cure. In other words, goods must seek the market more eagerly than the market seeks the goods. It is only in this manner that the "flow of goods" may again become subjected to a policy directed by the "flow of gold."

I am painfully aware of the fact that this exposition of the problem has been an unduly severe strain upon your patience, but the conclusions, to my mind, are simple and would not be as puzzling as apparently they are for many, if the causes of the disturbance were generally more carefully analyzed and better understood.

The debacle of foreign exchanges is the logical consequence of the financial anarchy prevailing since "King Gold" was deposed.

The discount of the foreign exchanges of borrowing countries is not the disease, but the symptom. It expresses the differential between various degrees of depreciation of money and credit, and between dissimilar grades of productivity in different countries.

When the equalizing power of gold, interest rates, and government credit has spent itself, the discount of foreign exchanges acts as the only remaining means of adjustment.

Foreign exchanges of the countries affected cannot be stabilized until their importations and exportations more nearly balance one another and until the process of dilution of currency and government credit is uniformly reduced, or arrested.

Rigidly balanced budgets are, therefore, required: because they restore the public credit; because they arrest further inflation; because they lead to curtailment of expenditures and increased taxation, which, if properly devised, makes for decreased consumption, increased production, and lower prices. And these in turn are essential because they stimulate exportations and discourage unessential importations, and thereby bring about the possibility of more nearly balancing the two.

For years to come the rehabilitation of currency standards and foreign exchange levels of borrowing countries will depend primarily upon the fiscal policy of their governments; it will be the character of their budget (including, as it does, the question of labor and increased production) that, more than anything else, will decide their future economic worth and development.

If we are agreed on these premises it is obvious why it would be foolish to think that in times like the present foreign exchanges could or should have been permanently "pegged."

Unless the flow of goods, or the issue of treasury bills and currency in payment of deficiencies, could have been arrested in borrowing countries, no lending country could have granted or absorbed loans large enough to keep on an artificial basis of parity things that intrinsically had become so dissimilar in value. Moreover, indiscriminately to grant such loans would have been an unwise and uncharitable policy for all parties concerned; because it would have pushed nearer the precipice both debtor and creditor country instead of leading them in the opposite direction, towards gradual recuperation.

For the vast number of American consumers, a recession of prices is of infinitely greater importance than boosted exports sold at high prices to purchasers whose natural limit of credit has been fairly exhausted.

For foreign countries buying our goods a decline in our prices would mean either a corresponding drop in their own prices or a recovery in their exchanges, or a combination of both. In any case, we would serve them better if we sold them at a lower price the minimum that they must have, than if we furnished them on credit and at high prices the maximum they might take.

After five years of suffering and sacrifices the masses at present are unruly, self-willed, and unreasonable. They are unwilling to submit to irksome government interference or drastic burdens of taxation. The lending countries, by insisting on the adoption of a balanced budget policy on the part of borrowing countries asking for new loans, and by reducing such credits to the very minimum necessary, would assist their debtors to choose a safe course, which, without such outside influence, their governments might not always be able to follow.

In formulating these general principles and observations one cannot, of course, be unmindful of the fact that there are certain emergencies involving the danger of so much physical and economic suffering that from the point of view of altruism and enlightened self-interest prompt relief would seem imperative. Where without outside assistance, reconstruction is beyond the grasp of a people, or where it is facing starvation or economic annihilation, there cannot be any doubt that we must do our full share in bringing relief, be it through private initiative or, if need be, through direct or indirect government action.

Except where plainly altruistic motives must thus exercise a determining influence, I believe that the time is near at hand when international bankers, considering new loans, will apply the strictest principles not only with respect to budgeting, but also with regard to the urgency of applications and the purposes involved. As it will be every citizen's patriotic duty to accumulate savings, so the aggregate gathered for investment will have to be looked upon as a sacred fund belonging to the nation, to be employed only where it will do the greatest possible good. World demands in the near future will far outdistance world savings and—if it were possible—nothing would be more timely than a "world priority list," regulating the use of new capital. These views, I fear, do not sound very encouraging to countries of our hemisphere whose future largely depends upon new development. Happily, however, several of them are in the class of lending rather than borrowing countries, and quite a number, through the emergencies of the War, have been taught to develop their resources and new industries and have made admirable progress in the direction of greater economic and financial independence.

My own belief is that capital in the Old World will find so vast a field in work of reconstruction and colonization in "darkest Europe" that it will not be able to devote itself as liberally to the development of the countries of this hemisphere as it did in the past. The three Americas will, therefore, be drawn together in a commercial and financial union of growing strength and intimacy.

The aftermath of war finance must be cleared up before countries may return to a pre-war attitude towards business. I believe that the United States is moving faster in this direction than almost any other country. According to the statement of the Secretary of the Treasury we have stopped increasing our public debt and have begun reducing it. We must persist in this policy and must now bend our efforts towards arresting and breaking the rise of prices; towards compelling greater industry and thrift, and towards distributing our undigested war obligations. It is very possible that in order to accomplish these aims, and to free ourselves from the last vestige of hot-house financing, we may temporarily have to submit to a period of liberal interest rates for both Treasury and commercial bills. While the immediate future, therefore, may not look bright, with a view to foreign financing on easy terms, we shall be all the stronger after we shall have gone through this process of purification, which will be the shorter and the easier the sooner we earnestly undertake it. We can now safely embark upon it without fear of a crash, while the problem might prove graver if we indulged in a policy of continued inflation and prosperity based on a further rise of prices.

If we keep our heads cool and act wisely; if we deal with our problems not from the narrow aspect of what serves best the single individual or single country, but from the broad point of view of what, at this critical juncture in the history of the world, is the course that is best for all, we shall be able not only to do our full share in the reconstruction and rejuvenation of Europe, but also in developing the intimate trade relations which, as a matter of logic and sentiment, must link together the sister republics of the three Americas.

APRIL 30, 1920

XXXIII

INFLATION AS A WORLD PROBLEM AND OUR RELATION THERETO

Address Before the Academy of Political Science in New York

THERE is no doubt that from the economist's point of view our topsy-turvy globe looks gravely ill just now. Mr. World lies prostrate, and the doctors at his bedside are putting their heads together in anxious consultation. A Princeton specialist diagnoses the case as one of acute inflation. If he could only arrest it he believes he could save the poor man. It is this terrible inflation, he contends, that causes Mr. World's high index temperature and disturbed circulation and that makes him consume so much and produce so little of essential substances.

"No," replies another Professor, "he is so inflated only because we cannot cure his condition of under-production and over-consumption."

"Nonsense," says Dr. Vandersnip, "you have doped him too much, that's what causes the trouble. Stop using artificial stimulants and drugs and he will come through."

"How could he have survived if I had not doped him," says Dr. Muchado, the surgeon, "and, having accustomed him to the drugs, how could I withdraw them from one day to another?"

"Let me stabilize him!"—urges Professor Irving, another specialist,—"his blood pressure is unbalanced; let me stabilize it, that would cure him forever!"

Poor Mr. World looks at his doctors and feels very low—he does not believe they quite understand his case.

What is the matter with Mr. World?

The truth is that he has just passed through a very severe attack of his old trouble—war. He has never been quite free from it. Every now and then he had a more or less acute spell. But whenever it was over he soon forgot all about it and, instead of trying to mend his ways and find a permanent cure, he went back to his old bad habits. This last attack, however, was so grave that Mr. World has made up his mind to sign a pledge that he will thoroughly reform his mode of living—if only he survives.

Will he make good when he gets well, or will he forget again? Who knows? But in any event the doctors must get him back on his feet and give him another chance. How can they do it?

Let me discuss the case not from the point of view of the learned specialists, but from that of the plain country practitioner.

In the life and death struggle of war sound economic precepts have to give way to the dictates of self-preservation. What orderly corporation could dare to issue millions of funded obligations for the purpose of covering running expenditures without any corresponding addition to its assets? But Mr. World increased his obligations by more than $200,000,000,000, while his plant and operating efficiency deteriorated at the same time. These loans were the drugs: they were necessary to save the patient, they stimulated his activities, they gave him a feeling of strength and confidence—while, as a matter of fact, each successive loan, like a drug, further weakened him and made recuperation so much more difficult.

Can there be any doubt that from the day of the Armistice it should have been our earnest endeavor as fast as possible to arrest the use of drugs, not only on the part of ourselves, but also on the part of our friends, and even our one-time enemies? But so thoroughly was the world "doped" that it took over a year from the date of the Armistice for nations to begin to recognize that they were living on a fictitious basis of prosperity; that by continuing to incur more debts, new wealth could not possibly be created, but that, on the contrary, by increasing the national indebtedness and currencies they were simply depreciating the value of investments saved in the past.

The historian will be amused to register the utterly impracticable and freakish theories and plans that, from time to time, were propounded when our generation was first faced with the problems of price inflation and depreciation of exchanges. To-day we smile at the thought that men who consider themselves leaders in economic and financial questions should seriously have entertained the view that prices could be permanently kept down by price fixing, or prosecutions, and that depreciation of exchanges was due largely to Wall Street manipulations; that exchanges could be kept at par simply by organizing a national institution which should clear all transactions in foreign exchanges.

To-day we have no difficulty in understanding that once gold payments are suspended, foreign exchanges largely express the differential between various degrees of price inflation and money depreciation in the various countries affected, and the different conditions of productivity and credit.

We have no difficulty, furthermore, in fastening in our minds the conclusion that now that the United States Government has definitely, as we hope, adopted a policy of living within its income, countries that persevere in covering current deficiencies by piling up additional indebtedness cannot expect to be able to arrest the fall of their exchanges in our markets by the simple process of incurring new foreign loans.

It is not my ambition in these short remarks to present any new views concerning the causes of inflation, which are generally understood, but rather to dwell for a moment upon the sequence and relative importance of its various stages as they impress the country doctor.

When war is declared the first thing that happens is that the government post-haste orders all the things immediately required for the carrying on of the struggle. (Simultaneously people are withdrawn from their regular occupations and others must be attracted to take their places.) The chief aim at that juncture is to get the things and to get them at once, the question of price becomes a consideration of almost negligible importance. Moreover, in order to stimulate production to highest efforts and beyond its normal peace capacity attractive prices must be offered. Large prospective profits, in turn, bring about a competitive demand for materials and labor, and prices are thus started on their long upward flight.

Government war expenditures are incurred with terrific speed and, as prices go up, expenditures rise in a constantly growing measure. War funds must be procured at once, while (aside from the dampening influence that over-taxation would exercise on the war spirit of a country and on its eagerness to increase war production) it takes time to pass laws, to devise new sources of revenues and to organize the machinery with which to collect taxes. Government bonds must, therefore, be issued and once the beginning is made, subsequent flotations follow in ominously quick succession.[1]

[1] Permit me to interrupt here for a moment in order to answer Professor Hollander who criticised the government this morning for having financed the War to so large an extent by the sale of certificates of indebtedness. To criticise is easy—is a French saying. I happened to have been right in the midst of things at the United States Treasury when we entered the War. Demands for money—hundreds of millions a week—were immediate. As already stated, it takes time to raise money from taxation; but it also takes time to raise it from funded loans. Months pass by in devising plans, getting the necessary authority from Congress, and preparing the organization for the distribution of the loan. During this period of preparation there is no other way than to raise the funds required through sales of Treasury certificates. By the time the issue of the long-term bonds is launched, the amount raised through the issue of certificates has grown already to so large an aggregate that the proceeds of the long-term bond sale hardly suffice to pay off the certificates and keep the government going for more than a very short time. Each issue of Liberty or Victory Loan bonds had to be larger than the available savings of the nation. Each issue forced the country to pledge its future savings and left a constantly growing amount of unplaced bonds. The speed with which

Moreover, high profits and high wages produced extravagance, and no matter how hard any government may try, it has been shown that everywhere government issues had to be placed in increasingly larger amounts than could be absorbed by the actual savings of the people.

It is at this stage only that banking inflation begins to become a factor of far-reaching importance. As long as the countries maintain the gold standard, the necessity to preserve the power to command gold, or the fear of losing gold, or the apprehension that banking liabilities are expanding beyond the safe limits laid down by law or tradition, act as effective brakes against over-expansion in banking and thereby on over-speculation and an excessive rise of prices. In normal times new evidence of wealth is produced by the addition of new tangible objects to the country's balance sheet, less what was consumed in the course of their production. Expressed in unscientific language, this is what would generally

funds had to be raised for the purpose of financing our Allies and ourselves was such that it was practically impossible to keep pace with the expenditures by the sale to the investor of funded obligations.

I cannot follow Professor Hollander when he claims that a certificate of indebtedness in itself is an instrument of inflation and the funded debt is not. If the investor buys the certificate in anticipation of the long-term bond, the certificate is no more an instrument of inflation than the bond itself. If a bank buys bonds and pledges them with a Federal reserve bank, it inflates every bit as much as if it had taken a Treasury certificate and pledged it. It is not the instrument, but what you do with it, that makes the difference. The investment market being congested, Treasury certificates had to be placed largely with banks, and often with a view to being carried by the Federal reserve banks. This meant inflation, no doubt, but no other way was open to pay for the War.

Whether more generous rates of interest, offered by the government on its long- and short-term borrowing, would have assured better distribution, whether it would have saved the subscribers some part of their present losses, whether after the Armistice higher interest rates should have been conceded more rapidly than they were—these are points on which observers may well differ. But that could only prove whether or not mistakes were made in handling the machinery; the machinery itself, which consisted of taxation and long-term bond issues, with intermediate sales of certificates of indebtedness, was, in my opinion, the best that could have been devised.

constitute the annual savings of a nation. To the extent that in normal times savings do not catch up with the production of new objects, bank credit temporarily will be called upon to fill the gap. But as long as a gold basis is adhered to, there is a distinct limit up to which this expansion may go, when necessity or caution will force a halt. Banking expansion normally increases, therefore, in a definite relation to actual savings—hot-house growth on top of actual savings being limited by the relation to gold reserves which must be maintained. In times of war these boundary lines are removed. The steel ring that before held tightly in its grasp the bulging bale is now converted into a weak rubber band. Investments and deposits grow, not as tangible assets of value are added to the country's resources, but they are swelled by government obligations issued for services of no lasting value, and even for work that destroys assets instead of producing them. Moreover, the rise of prices naturally increases the loan structure, which can now grow without let or hindrance, for serious consideration is no longer given to the shrinking of the gold reserve and, savings being unable to absorb government bonds as fast as they are issued, reserve balances are created and currencies are issued against loans on government bonds, or as in some countries, against direct advances to the government. As long as reserve balances are created and circulation is issued only against self-liquidating paper, which represents things in course of production, and as long as this process is kept within a safe relation to gold, there may be more or less acute banking expansion, but there would not be any cause to call it inflation. It is when bank loans, reserve balances, or circulation are being created against things that do not represent any tangible value, and gold reserves are disregarded, that we face inflation in its classic form. Indeed, with us that inflation took place, when government securities to the extent of approximately one and a half billions became the basis for Federal reserve bank loans, even though, due to particularly fortunate circumstances, we were able to preserve a remarkably strong gold cover. (This was only possible, however, because at the beginning of the War we had a vast gold treasure wastefully decentralized, in scattered bank reserves, or in actual circulation, and because we were able to concentrate this gold effectively, and to add to it a billion dollars which came to us from foreign countries.) It is of the utmost importance that we realize the fundamental—though in protracted wars unavoidable—part played by government borrowing in causing inflation. I can hardly perceive that inflation could have taken place in any country enjoying a modern elastic and well administered banking system, if government printing presses could have been prevented from doing their nefarious work.

We must clearly bear in mind the three different stages in the process of war inflation: first, rising prices caused by the precipitate demands for goods by the government and accompanied by disorganized production; second, depreciation of money caused by the process of rapidly increasing the national debt (in form of bonds or currency) in excess of the country's saving power; and finally, inordinate bank credit expansion, degenerating into inflation as a consequence of the dilution of reserve money and circulation through direct or indirect government loans. It is true that as bank-credit inflation progresses, it, in turn, becomes an active factor in depreciating the value of money and in boosting prices. But, to my mind, this development is the evil counter-effect of the other two, not, as some economists appear to think, the primary cause.

You may ask: Why lose so much time in this analysis of causes and effects? Because the word inflation, though covering a multitude of sins, is often used as designating one disease, and as a consequence, there are many that seek relief in one single remedy, while it is all-important to grasp it as firmly as possible that Mr. World is not suffering from any one particular sickness, but from several. He is at present like a patient suffering from a broken leg, a toothache, and an attack of pneumonia. The three things combine to make him feel miserable, but each ailment must have a separate cure.

Increase of government indebtedness must be arrested, and national budgets must be balanced, by reduction of expenditures and increase of revenues. (Indeed, wherever possible, a gradual amortization of government loans must be sought.)

The inordinate demand for things must be met by increased production and by greater moderation in the extravagant consumption of goods.

Banking inflation must be combated by an earnest attempt to reëstablish and preserve the healthy check placed upon us by a conscientious observance of our gold obligations, which implies a stricter control over bank loans and a greater effort to liquidate excessive loans, commercial and governmental, by savings.

The world as a whole must tighten its belt if there is to be enough for all. That belt is a strict control of credit without which the world will continue to gorge itself and inflate.

While to the layman rising or falling gold reserves may serve as the most impressive gauges from which readily to judge to what extent our banking situation gains or loses in strength, as a more reliable standard to indicate banking expansion, and its effect on price levels, we should at this juncture rather watch the item "total investments" in the Federal reserve statements. We might be forced to export hundreds of millions of gold, seeing our gold reserves correspondingly reduced thereby, and still be justified in continuing to do our business without disturbance or alarm; our general position of overtowering strength remaining unaffected, due to the large debts the world owes us. On the other hand, we might gain several hundred millions of gold, which would increase our gold reserves, but we should not be inveigled thereby into establishing lower interest rates or into encouraging a planless increase of the Federal reserve bank item "total investments," which would involve further banking and price inflation. Larger gold holdings would simply indicate that we should have accumulated greater strength for the possibility of such expansion provided that, in due time, it could be based upon the natural growth and the solid foundation of increased production and actual savings.[1] It must be our first concern,

[1] It is obvious that this paper could not possibly presume to give an exhaustive or scientific survey of the whole problem. I am dealing with the question of inflation only as it affects modern central bank countries. In these, a loss or gain of gold does not automatically increase or decrease inflation. The potentiality of greater expansion or contraction is increased in each case, but the powers and the discretion of those in charge of the System play an important rôle in determining the immediate effect. In a primitive country, having nothing but a plain gold circulation and little or no deposit banking, an influx or outgo of gold might have an immediate effect on prices. Conditions are vastly different in countries with elastic note issues and immense deposit structures (approximately $42,000,000,000 in the United States) where the basic gold dollars (estimated at less than three billions) form only a very small amount when compared with the superimposed pyramid of credit dollars (circulation, deposits, bills, checks, etc.). It appears extremely doubtful that by giving a smaller or larger gold content to these basic dollars as far-reaching results could actually be obtained in the direction of stabilizing prices such as are expected by the proponents of the plan of stabilizing the dollar. (Professor Irving T. Fisher.)

They claim that the weakness just outlined could be remedied by pursuing a reserve and banking policy strictly in line with the basic gold policy as directed by index numbers. They concede that in case of extraordinary fluctuations stabilization would break down as soon as it should be necessary to suspend gold payments; indeed, that it would have broken down during the War and that it would probably precipitate an earlier collapse of gold standards in future cases of abnormal strains. I believe that most students of such stabilization agree, furthermore, that if it could be taken up at all, it would have to be on international lines. In that case, it would appear most improbable, however, that even in the case of minor fluctuations central banks could carry into actual effect a plan likely to involve a simultaneous demand for additional gold on the part of many countries, or, failing to secure gold, a simultaneous determined effort to contract outstanding note issues in the countries affected. That, indeed, is the very thing central banks would probably be unable to bring about in such times. To illustrate, let us suppose that England and we had stabilized the pound sterling and the dollar a year however, to get the world back upon a basis of normal production and if it should become imperative for that purpose temporarily further to expand—then, I believe, and only then, should we be prepared to make an exception to this rule and permit it. When an engine reaches the dead point, we often have to reverse it in order to get the train started in the right direction. When we have a weak customer, who owes us a great deal of money, we sometimes have to loan him more in order to enable him to get over his difficulties and pay us back. In other words, we must arrest planless inflation, caused by hysterical competition and crazed speculation and extravagance, and husband our resources so that we may use them courageously when we know for certain that expansion is devoted to purposes that ultimately will bring a cure; that it is a definite means toward a definite essential and constructive

ago. In order to hold prices on the stabilized level, it would have been necessary for both to increase their gold holdings, and having found it impossible to draw gold in sufficient quantities from the rest of the world, they would have had to attempt a reduction of their currencies so as to increase the percentage of the gold cover to a degree corresponding to the rise in index numbers. But we must ask ourselves, how could they have succeeded in actually reducing their outstanding currencies? Both countries, as a matter of fact, have been striving for that result and have failed. Does an announcement of the intention to stabilize give the material power to do so to any larger extent than our present wish and will to arrest inflation? By what means could governments be expected to reduce outstanding currencies? The answer is: by raising the necessary funds through increased taxation and by cancelling a corresponding amount of circulating notes. But does the will to stabilize force legislatures or enable countries to raise, or submit to, additional taxation in order to cover their deficiencies any more than the present will to arrest inflation? We doubt it, and doubt it very seriously.

Bearing in mind that the stabilization plan does not promise any protection against the fluctuations caused by any abnormal stress; bearing in mind, moreover, that if carried into effect it would involve the rescinding of all existing sacred pledges to pay "in gold of the present weight and fineness," bearing in mind, furthermore, the additional difficulties and doubts I have just outlined, and others that it would lead too far here to discuss, I believe very strongly that the practical advantages to be gained do not outweigh the disturbances, dangers, and disappointments that, to my mind, would follow from its adoption.

end which, in this case, is to arrest the endless rise of prices and prepare the way for ultimate deflation.

It is important, however, to recognize that inflation will only capitulate if a concerted attack is made from all the three sides I have described. Banking contraction alone cannot effectively be brought to bear if the government continues to increase its indebtedness in payment of current deficiencies, nor can it succeed unless production is increased. By attempting to curb loan expansion and government issues, we may at best prevent a further rise of prices but we cannot hope substantially to reduce prices if, in addition, we do not manage materially to increase production, unless, indeed, consumption be decreased to a larger extent than at present appears possible.

And this leads us to another very obvious conclusion, which is that, with labor conditions what they are and extravagance being what it is, it is foolish to expect that the few countries living under fairly undisturbed economic and social conditions could speed up their lagging production to a degree sufficient to make up the deficiency caused by the voluntary or enforced idleness of countries in Europe involving more than 200,000,000 people.

The world before the War had become one closely interrelated economic unit. The products of the mines of Chile and Norway had become as important components of European and North American industrial life, as Brazilian coffee and Chinese tea had grown to be integral parts of our diet, and Manchester or Chemnitz goods had become necessaries in the lives of the Chilean and Australian. Two countries, geographically remote from one another, might face ruin or starvation unless they could exchange foodstuffs, or coal, or other goods and materials. The War, and the social upheaval following in its wake, have brought about drastic changes in the relative positions of capital and labor. The latter, in the future, will insist upon a larger share in the results from its work—and will claim this larger share, moreover, for a smaller return in work.

In the face of these circumstances is not the inference all the more inevitable that it is idle for us to assume that we could get the world back into a condition where goods seek the market more than the market seeks the goods, in other words, that we may come to see an era of receding prices, until the entire world returns to a fairly normal state of production and interchange. Until that is done, the demand for goods will dominate the situation; and as long as the demand for goods reigns supreme, labor will have the whip hand both as to wages and the services it is willing to render at any price. We cannot expect to get control over wages and prices (nor can constructive labor master its own difficulties) until the world as a whole puts its house in order and until labor in Europe competes again with labor over here.

It is quite evident that such glaring disparities as at present exist between our own prosperity and the acute suffering in some parts of Europe will not be permitted to prevail in the long run. Unless we indulge in the impossible assumption that whole nations can be caged up, so that they may perish of disease or starvation without disturbing their neighbors, we must expect that by sheer force of necessity these hungry and desperate hordes will come over here in order to share with us our own plenty and opportunities. Some twenty or forty millions of additional immigrants, to be fed and clothed by us, would quickly solve a substantial part of our problem of placing our excess production. Would such extreme development, however, be the most economical, the most humane and, for us, the most desirable solution; and, if not, what is the alternative?

Over here we have a shortage of labor and an over-supply of raw materials. Over there, Europe has an excess of labor and a shortage of raw materials. We have high wages; Europe has lower wages. We have too much food; Europe starves. We are the world's creditor; Europe is in our debt and has not the means with which to settle. Is not the logical solution of this problem that our capital should go right into the countries that at present most need a helping hand? Instead of increasing certain plants in our country where there is a shortage of labor and higher prices, would it not be logical that we assist in putting into operation similar plants in countries with excess labor and lower prices, where, in consequence of the unprecedented depreciation of their exchanges, in some cases we could buy factories or properties at a fraction of what it would cost to reproduce them here? Is it not obvious that by furnishing European countries with raw materials and credits, we would help them to restart their economic life and place them in a position where they can pay their just debts and where, in the long run, they can work their way back to approximately the same standard of living they enjoyed before the world was thrown into the turmoil of war? The ways in which this could best be done would differ according to the varying political, social, and economic conditions of the countries affected. In some the usual methods of granting short-term banking credits and of buying securities, foreign or their own, may still be applicable. In others, where foreign exchanges are subject to violent fluctuations, or where the local currencies have become so depreciated that in world markets they have practically lost their purchasing power, it may be advisable to combine the sale on credit of raw materials with a contract for the sale of the finished articles, into which the raw materials are to be converted. In others it may prove the best solution to buy part ownerships in existing factories or plants.

There never was an opportunity for an undertaking more tempting from the economic point of view and more appealing as a work of healing the wounds that a crazed world has inflicted upon itself. Governments have shown that they are capable to direct, and that they can unite in directing, the work of destruction. In coöperative work of reconstruction, most governments, so far, have shown themselves dismal failures. The bulk of that work (barring relief to be given to peoples facing extirpation or decimation by starvation, disease, or economic ruin) will have to be carried on not by the governments, but primarily, it would seem, by the direct initiative of the peoples.

One could fill a large volume in discussing the question of private enterprise vs. government operation. It has well been said that either our political and economic problems must become smaller or our leaders must become bigger. Tested by billion dollar and one hunderd million people units, the human genius and capacity of the present generation has been weighed and found wanting. Speaking by and large, I think, therefore, we should beware of drawing any government into activities it could in fairness avoid. The larger the government's scope of operations, the larger must be the number of billions it must raise. Excessive taxation is a wasteful and uneconomic procedure, because it continuously withdraws funds from points where they have converged for productive purposes and at once scatters them again. It is a violent and haphazard process of distribution—funds often being taken from those that produce in order to be placed in the hands of those that waste—and at best it involves a long, continuous, and costly interruption of the flow of money into the channels of production. Moreover, whenever the government's expenditure moves ahead of the country's saving power, this distribution takes the form of inflation.

Inflation, as we all know, is the cruelest and unfairest method of taxation. It arbitrarily decimates entire classes of the most valuable elements of our population and blindly enriches others, among whom are those who gamble and profiteer in the very things the world most urgently requires. The heavier a country's burden of expenditure and the vaster the volume of funds it must collect and distribute, the more drastically does it interfere with the healthy development of private enterprise and the nearer does it draw to the fatal abyss of so-called "socialization" or "nationalization."

Bearing these circumstances in mind, one cannot but follow with genuine alarm the impending danger of seeing the government committed to an expenditure of more than $1,500,000,000 involved in the contemplated soldiers' bonus legislation. It threatens to lead to the alternative of overtaxation, or increased Treasury borrowing of a temporary or more permanent character. In one form or another it would, therefore, lead to inflation or disturbance and delay the ultimate adjustment.

In closing, permit me to sum up the practitioner's advice in the case, as follows:

We must fight inflation with all the means at our disposal:

First, by arresting the further increase of government indebtedness and, if possible, by reducing it;

Second, by trying to call a halt on further bank credit and note-issue expansion, destroying thereby the atmosphere of easy money and paper prosperity that makes for individual and corporate extravagance, and fosters discontent among the masses, and renders them disinclined to give their full measure of work. In doing this we must boldly tackle the most difficult task of curbing the production of unessentials and of stimulating the production of essentials;

And finally, we must fight rising prices by stimulating essential production, not only here but also abroad, which means that we must furnish Europe with the materials required in order to rehabilitate her industries so that once more she may become self-supporting. As far as this involves the granting of further credits, it should be our determined purpose to provide them from our savings; if we are incapable or too irresponsible to accomplish this, we must submit to paying for the unsaved balance by inflation. That would prove, as we have seen, a wasteful and highly regrettable alternative, but it is easier for us to bear the sacrifice than for Europe. Moreover, by curbing extravagance it is in our own hands to counteract the evil effect of such loans. Irrespective, however, of the moral or humane issues involved, from the purely selfish and practical point of view, we know that unless we help Europe to preserve her industries and social institutions, we may not ourselves hope to regain control over prices and wages; and social unrest and disorder in Europe are bound to throw their shadows across the Atlantic and the Pacific.

Further inflation, carefully measured and applied, may thus become a painful remedy in case we fail to master our extravagance. Obviously, we must not permit the dose to be made one single grain heavier than the most conscientious study, and our most determined efforts to avoid it entirely, may warrant. This duty of carefully restricting to the minimum this measure of our support is an even graver one with regard to its recipients than with respect to its givers. For European countries of to-day are staggering under the load of their debts; any new obligation adds further to their burden, and increases the difficulties of their ultimate recovery. Support must, therefore, be restricted to the minimum that would remain as an imperative and irreducible requirement after a country abandons its vicious war habit of printing notes and obligations in order to cover current deficiencies, and after it arrests the flow of easy money and credit that encourage extravagance. For no good purpose could be served by pouring water into a tank without a bottom.

Mr. World cannot be cured by fake patent medicines, but only by sound habits of hard work and thrift. Moreover, Mr. World must remain conscious of the fact that his body has many component parts, all of which must be brought to their normal functions before once more he will feel truly comfortable and happy.

Sir Auckland Geddes expressed this thought in a recent speech when he said: "Until Europe is herself again, our own conditions cannot be normal, and the problem of restoring Europe is largely bound up with the fate of Germany, Austria, and Russia."[2] Our relation to Europe as a whole is not different from that of England to the Continent.

In other words, in solving the problem the same rules apply to all of us. If, in order to help Europe to return to a basis of order and increased production, we are to tighten our own belt and save, or, failing that, to bear the additional burdens of inflation, Europe herself must do her share whole-heartedly in bringing about that result. We can help Europe to regain her productive powers only as European countries help one another in that respect.

With that great force and straightforwardness which we have learned so deeply to admire, Signor Nitti said: "War and peace are not only facts. They are states of mind. The trouble with the world to-day is that it is still in a war state of mind. It must get into a peace state of mind. The War is over. Let's have peace. Every man and nation must produce to the utmost. Without real peace the nations cannot produce."

No truer words have been said. Even though, through a pitiful combination of circumstances we, of all nations, are technically still at war, and thereby forced to stand aside at the very moment when we should be leaders in the front rank, the all-important fact remains that the War ended a year and a half ago, and that reconstruction and peace must at last become an actuality among the nations. Not until a clear and practicable program is laid down for Europe's future economic life, and not until our own relation thereto has been definitely established, shall we reach a basis on which America will be able to throw herself confidently and unreservedly into the task.

Encouraging progress in this regard appears to have been made at San Remo during the last week and it is to be hoped that the next two months will at last bring a definite and clear basis for a world at peace. No more auspicious moment could have been chosen for the convening of an International Financial Conference, now called together by the League of Nations for the end of May, at which these puzzling economic and financial problems are to be discussed by experts from all the countries affected. It is greatly to be wished that the United States, officially or unofficially, may be represented at this gathering. A full and frank disclosure of prevailing conditions in lending and borrowing countries will convey to all participants the much needed information concerning basic facts, without which a comprehensive remedial action cannot be confidently undertaken. It will acquaint the borrowing countries with the limitations of possibilities, and the difficulties prevailing in lending countries. On the other hand, closer knowledge of progress already made in some of the borrowing countries would instill greater confidence on the part of the lender, while, in other cases, it would impress the would-be borrower with the necessity of taking certain measures prerequisite in order to enable the lender to render support. My own feeling is that the conference will find that requests for direct financial relief on the part of governments will form a comparatively unimportant part of its recommendations. I believe that the conference is likely to reach the conclusion that the main rôle of governments at present will be—to use a slang expression—to remove "the monkey-wrenches that have been thrown into the machinery." It is uncertainty, disorganization, and obstruction that hurt Europe more at this time than lack of raw materials and credits. If governments will coöperate in eliminating these obstacles, I believe that most of the very grave difficulties, now existing, and still to be met as we progress, can be overcome by individual effort and ingenuity. It may become necessary, for that purpose, to organize private enterprise to act in large national units, and these in turn may have to group themselves internationally for the purpose of combined coöperation; but I can well imagine that all of this can be brought about with comparatively little direct financial support on the part of governments, but with their unreserved moral backing and sympathy.

I should, furthermore, hope that our representatives would come back from the conference with a message inspiring enough to give us the impulse—sadly gone to pieces since the Armistice—for a common plan of action in finance and business. Think what we might be able to do to-day if the billions absorbed by speculative and unessential enterprises had been used to pay for Liberty bonds (which in some years from now will prove to have been a better speculation at present prices than many stocks) and if in bank portfolios we could have replaced war paper by a corresponding amount of bankers' acceptances. But how could we expect to free half a billion of dollars, with which to finance raw materials and goods moving to and from all parts of the world, if million-dollar crack-apartment-houses, oil speculations, corners in motor stocks, and the like, are permitted indiscriminately to absorb available credits and investment funds, even though the loans of our commercial banks during the last 11 months show the alarming increase of 25 per cent. It is true that we are tired of governmental regulation and paternalism, but they can safely be avoided in present circumstances only if voluntary regulation and self-discipline will assert their influences in combating financial anarchy. The conference could not fail to make emphatic recommendations concerning what is to be deemed "essential" and "unessential" for the general good, and I hope that their findings may arouse us over here to common action in that respect.

The experts would probably agree on the further conclusion that the case before them is so complex that any broad rule adopted will have to be applied with discretion, taking into careful consideration the particular conditions of each country. Furthermore, they may be relied upon to be in accord as to the advisability of not depriving a patient of his crutches before he is able to walk.

When once the problem is thoroughly understood in all its intricate phases, and when a clear and practical program is adopted assuring the Old World's future peace and prosperity, I have the abiding faith that America will do her duty toward Europe honorably and fully.

From aristocratic ages we have taken over the old beautiful saying, *noblesse oblige*. Translated into plain democratic American language it means that we cannot seclude ourselves and aspire to live in wealth and contentment, while the rest of the world suffers poverty, starvation, and distress. If we were willing to accept that position, we could no longer keep our heads high as citizens of the United States when in the future we gaze into the eyes of our fellow-men.

It would be a tragic irony of fate if the most unselfish and most generous effort ever made by a nation should lead to such a pass. That outcome is unthinkable. No matter how much at present we falter and flounder, that ultimately we shall rise to the standards of our proud traditions, nobody can doubt who knows and trusts in the fair-mindedness and self-respect of the American people.

DECEMBER, 1920

XXXIV

EUROPE AT THE CROSSROADS[1]

BETWEEN Agra and Delhi, surrounded by the wild woods and jungle of India, lies the deserted city of Fatipur Sikri. It was twenty-eight years ago that I entered its deep silence in the middle of the night, the moon throwing her mysterious light upon the sleeping walls and towers, which seemed to dream of the splendors and glories of centuries gone by.

The memory of that picture remained deeply engraved upon my mind. In brown granite, which the rough hand of time had not been able to touch, there stood before me, practically intact, the residence of mighty King Akbar. There were his palaces, his treasury and the buildings of other heads of departments, the house of worship, and the strange little hall, shaped like a lantern, where, in the middle on a high pillar, presided the King, while in each of the four corners, from which narrow stone bridges led to the column in the center, sat a representative of each of the four leading religions: a Hindu, a Mohammedan, a Christian, and a Jew. It was King Akbar's ambitious plan to take the best of all creeds and to blend them into one great religion. He had wives of all these denominations (and probably more), whose individual houses still stand in all their grace and charm.

Whoever visits this remarkable spot, with a mind not entirely barren of imagination and not completely devoid of reverence for the eternal growth and struggle of the human race, cannot but visualize a great leader, powerful and chivalrous, bold and refined, who sought to find a way of removing

[1] Reprinted from the Political Science Quarterly, Vol. XXXV, No. 4, December, 1920.

the causes for bloody strife and misery resulting from narrow intolerance, hatreds, and jealousies between nations, creeds, and races. It would seem that in his own way, he tried the experiment of a League of Nations—and to-day there is nothing left but deserted houses of brown granite standing silently in the wide wilderness. And what occurred five hundred years ago has happened over and over again a thousand, and several thousand years ago. Then, as to-day, nations rose to their full glory and then tottered and fell into pitiful unimportance and decay.

Who can think of Egypt, Babylonia, Greece, Rome, Carthage, or Byzantium, and believe that modern Europe has a charmed life as a leader in progress and civilization? We are prone to believe that the world has grown old and that certain conditions have reached the final forms in which they are to stay. But the world is as much in a state of flux as it ever was. The migration of the people is as active in our generation as it was 2,000 years ago. Our large steamers transport in a week more people than Hengist and Horsa or William the Conqueror carried into England. Civilization, starting in central Asia, kept on marching west—to Asia Minor, the Mediterranean, and eastern Europe. A few generations hence will the historian find that it crossed the Atlantic and made America the standard bearer? Who knows? It will depend upon Europe's ability to arrest the present process of disintegration before it is too late. Let us hope that the wellsprings of European civilization will not be dried up. We cannot spare the inspiration and the contributions of the Old World. The decay of one country does not mean the corresponding rise of another. On the contrary, closely interrelated as all peoples are to-day, retrogression in one involves the lowering of the general level of the standards of living and progress of all.

When men of science, clad in rags like beggars, are cleaning the streets, because in following their literary pursuits they can no longer earn the pittance paid to the women who used to tidy up their rooms, when scientific books can no longer be printed on account of the expense involved, do we not see before our minds' eyes the phantom of hundreds of Fatipur Sikris arising in Europe?

A great war, like a severe illness, always leaves the participants in a condition of exhaustion, which can be overcome only after a long period of recuperation. The speed of the recovery depends upon the extent of the ravages, not only of the war, but also of the peace. The wiser the peace, the sooner the return to normal economic conditions, and the quicker the consummation of the healing process.

Violent social evolutions, like the transformation of slave-driven, pagan Rome into a Christian world of free men, or like the supremacy of the *tiers état* as the result of the French Revolution, have left countries in a similar protracted state of intense suffering and confusion.

Few people realize clearly enough that the world at present is suffering not only from the aftermath of four years of one of the fiercest wars ever conducted, and of two years of continued extermination after the cessation of open warfare, with actual peace still unaccomplished, but also from the consequences of a social evolution as far-reaching as those connected with the liquidation of the Roman Empire and the *ancien régime.* It is this combination of circumstances that renders the problem so complex and so desperately grave and should make us apprehend a long period of recuperation.

Europe at present is like a big steamer sunk by a torpedo. It is idle to discuss to-day what kind of Ritz restaurant or social hall she should have when she is afloat again. The first question is: "Can we raise her at all?" The second is: "After we raise her, can we repair her engines and make her go?" It is evident that we cannot raise her without first stopping the leak—the breach, still wide open, between France and Germany; we cannot make her go without straightening out her machinery—that is, without settling the labor question. When these two tasks are disposed of, I am confident the good old ship Europe will gradually right herself. It is to these two outstanding problems that we must devote ourselves, body and soul, if we want to save her from fatal disintegration.

It will probably prove the greatest tangible result of the War that, all the world over, labor has ceased to be considered as simply a dead item in the cost sheet of production. Labor, instead of being a means, has become an end in itself and (in the language of Immanuel Kant) is the inalienable right of every human being.

At present the world is divided into four camps. On the far right and left we see the extreme and destructive wings of capital and labor, respectively. We find the Bolshevist and his like as unmindful of the human rights of others as the ultra-capitalist and nationalist. Wedged in between these two there are progressive capital and constructive organized labor. It is by the union of these two constructive factions that we may hope to save what will prove worth preserving of our old society. Of these two, however, conservative organized labor in Europe has shown itself more capable and quicker to recognize its duties and opportunities than unorganized progressive capital. Constructive organized labor has found ways to get together across national lines, and it has shown the courage and vision to think and act, both nationally and internationally at the same time. It is conservative organized labor in its various forms—let us make no mistake about it—that so far has stemmed the tide of Bolshevism in Europe. It is on the sanity and sagacity of the leaders of conservative labor, more than on any other factor, that Europe's hopes must rest to-day.

Unlike the Bolshevist, conservative organized labor does not wish blindly to confiscate and destroy, but to preserve and construct. For that reason it does not approve of imposing on its former enemies contributions in excess of any endurable or practicable means of taxation, which would send the debtor nation on the certain road to complete depreciation of its currencies, with resultant bankruptcy and violent social upheavals, such as have annihilated Russia.

At the British Trades Union Congress held at Portsmouth during the summer, we find the Joint Committee on the Cost of Living submitting a report on money and prices, in which occur the following passages: "As regards the international aspect of the problem of high prices, we think that: (*a*) the reestablishment of peace throughout the world is a prime essential; (*b*) war indemnities should be defined and reasonable in amount." Other paragraphs in the report run as follows: "We look to the development of productive capacity all over the world to bring about ultimately a substantial fall in prices." "The government should cease entirely to resort to bank credits to meet expenditure," and, "The floating debt should be wholly or largely repaid, the remainder, if any, being funded." Lack of space prevents my mentioning other passages worth quoting and others worth contradicting; but the above extracts are highly significant of the admirable progress of thought made in these circles.

This progress is not confined to English labor, for we find the "Second International" at Geneva committing itself in the most unqualified fashion against Bolshevism and, at the same time, against the extreme clauses, or interpretations, of the Versailles Treaty.

It is interesting and most encouraging to find progressive capital in Entente and neutral countries in practically complete accord with conservative organized labor on these points. In talking to enlightened leaders in London or Paris, Brussels or Amsterdam, and to Swiss and Scandinavian bankers, I did not find any divergence of opinion on the proposition that the determination of the maximum measure of indemnity that Germany would be able to bear, and survive, was the one outstanding question to be satisfactorily disposed of before any headway could be made toward starting Europe on a course away from the social and economic collapse toward which she is now headed.

British financiers were most outspoken in this respect. They are keenly alive to the fact that every day that the solution of this problem is postponed means that Germany is sliding nearer the precipice, and it is realized that to-day she is dangerously close to the brink and that her plunge would no doubt involve others. British leaders complain bitterly about the powerful coterie in the English and the French press that keeps the public in ignorance of the true state of affairs in other countries, that fans hatred and suspicion and blocks the way to a fair settlement.

But, somehow or other, leaders of business and finance have not been able, as effectively as labor has, to get across the national border lines, cutting loose, if necessary, from the apron strings and embargoes of party governments. They have not been able to get together as independently upon a broad international program. Their efforts have remained unorganized, sporadic, and timid, while the governments that hold them in leash have not been able to emancipate themselves from the sway and influence of the chauvinists. This is because capitalist society, as represented by the various governments, has not been able to shake off its extremists as rapidly and as energetically as conservative labor has. It is largely because of this and because these governments are too slow in retracing certain steps—taken inadvisedly, but explained by the temper, time, and stress in which they occurred—that labor has lost its confidence in their efficiency and moral strength. Labor, therefore, defies their authority by recourse to so-called "direct action."

It is unnecessary for me to say that I am not an advocate of "direct action," nor am I blind to the grave blunders that labor leaders have made. They have overreached themselves at times, like all other leaders. But no government can rest its success and authority upon the mere exploitation of the wrongs done by its opponents. If it wishes to survive, it is most essential that it clear its own skirts of mistaken acts or policies. At present the Bolshevists and radical labor find their strongest moral support in the mistaken deeds, past and present, of governments directed or controlled by the will or fear of the bitter-enders and militarists.

Every revolution, born of rights wrongfully withheld, brings forth wild schemes that swing far beyond the line of reason, fairness, or feasibility. Bolshevism is a case in point. Its insane, cruel, and extreme methods and principles will ultimately bring about its own undoing.

In the struggle between the masses and the classes neither side, however, can win by strong-arm methods. In the long run, neither a dying form of government or creed, nor a new one aspiring to take its place, can maintain or assert itself by the use of the sword or the torch. Anarchism cannot effectively be fought by deportation, nor can it win by the use of dynamite. That form of government will ultimately prevail which most honestly lives up to the code of honor and ethics it professes and which goes farthest in observing the law, within and without the national lines, of loving one's neighbor as much as oneself, which, in other words, fully recognizes and respects the just rights of the other fellow. It is not a test of strength, it is a test of morals that the world is faced with, and the sooner we realize that fact and attack our problems from that angle, the sooner we shall emerge from our present difficulties.

The masses, harassed and distressed by the present trying conditions, will not be satisfied until some satisfactory solution is found. It will be one of the essential requirements of that solution to give labor a proper voice in the management of its affairs, an adequate living wage, a share in the profits, if possible, and perhaps some sort of direct influence in the government. The safest bulwark against Bolshevism is some practical experiment of this character, which would go to the utmost limit compatible with the strict observance of the principle of the sanctity of private property, the preservation of individual efficiency, and of strict submission to the majority rule of a parliamentary government.

Germany is trying such an experiment at this time. She has enacted legislation making obligatory the organization of shop councils in every establishment employing more than a given number of hands. These councils have certain rights with respect to the working conditions of the employees and also may have one or more representatives on the boards of directors of corporations. Representatives of these councils are grouped together in superimposed organizations in order to deal with questions affecting an entire industry or profession. And finally, members of these larger organizations are delegated to act on the Economic Council of the entire Republic, which Council acts as an advisory body to the Parliament. One can readily see the vast possibilities of such a plan which, in effect, creates a second house of non-political experts, in which all important unions, guilds, and professions are represented. There would be no need or pretext for "direct action," particularly if this body of experts in due course of time were endowed with the same rights and powers as the political chambers. It is not beyond the bounds of imagination to suppose that, instead of two political bodies, like the House of Commons and the House of Lords, or the House of Representatives and the Senate, nations might in the future have one political and one economic parliament. From what I have been able to learn about President Millerand's plans, they appear to follow a similar trend of thought in proposing to make the French Senate more representative of the guilds, trade unions, and chambers of commerce of France.

Recent history has shown that democratic, as well as autocratic nations, are delivered into war and into peace without being able to discover, express, or assert their will. The people of the United States could neither go to war nor end it when they wished to, nor could they make their own peace. The recent election, with platforms and speeches on both sides that did not dare unequivocally to state what the victorious party would do, does not tell what the people really wanted. Why have both houses elected in the same unsatisfactory way? Would it not prove of the greatest advantage to elect as the second chamber a non-political body to which the best manufacturers, the best engineers, the best bankers, and the best representatives of labor and agriculture etc. would be delegated by their own professions? It is realized, of course, that for the United States a development on these lines must be considered as entirely remote, but of all the interesting evolutions taking place in Europe at this time, it strikes me as one of the most significant and as one deserving our closest attention.

Bolshevism seems dead one day and full of life and vigor another. But whether Lenin and Trotzky retain their strangle-hold on Russia or whether they go under, a practicable solution must be found which will satisfy reasonable demands of labor. Without some such settlement labor in many countries will not quiet down and increase production sufficiently to arrest the fall of their exchanges. Nor may we expect that without such a settlement labor will submit to the overwhelming burdens of direct and indirect taxation, without which increasing inflation and ultimate bankruptcy cannot be avoided. The more desperate the economic needs of a country, the weaker the authority of its government, the greater must needs be the concessions made to labor. Italy is a case in point. It is significant, furthermore, that after Germany was compelled at Spa to concede to the Allies the monthly delivery of two million tons of coal and the reduction of her army to 100,000 men, she had to embark at once on a scheme for the nationalization of her coal mines, with a profit-sharing plan for labor and owners, and with ultimate complete government ownership. Failure to offer some such plan would at once have played into the hands of the Independents or Spartacides and, at the same time, would have exposed Germany to the dangers threatening her from non-fulfillment of agreement in the punctual delivery of the coal.

The inferences are obvious!

If Germany fails in these scientific and orderly attempts to solve her labor troubles, it will lead to either more bolshevistic experiments or to reaction and civil war. If she succeeds, on the other hand, how long will it be before other countries will find that they will not be able adequately to increase their production unless they, too, grant similar concessions to labor? Should not victorious countries take care lest driving Germany to extremes might prove a boomerang for themselves?

Nationalization, or socialization, is a thought that casts a great spell upon the imagination of the laboring masses, even though from the fiscal as well as the economic point of view it has generally proved itself an inadvisable, uneconomic venture, to be avoided wherever possible. But where economic and social conditions have become desperate, or where just demands of labor have been neglected too long, nothing will satisfy the exasperated masses but the fetish of nationalization, and radical concessions in one country will at once affect conditions in others.

The great majority of the German people abhor Bolshevism; they are temperamentally an order-loving people with a passion for hard work, even though at present dishonesty, corruption, and even barefaced robbery have made alarming inroads among the distressed masses. The great majority of the German people abhor reaction and are through with the militarists. They want to work out of their present distress and pay any reasonable indemnity that may be imposed. Individually and collectively, however, they are at the end of their tether. They are undernourished—they still live on pitch-black bread, that during my stay contained only 20 per cent of flour—and tuberculosis is spreading at an alarming pace. Their death rate has increased tremendously.[1] Taxation in a hundred different forms takes an amazing proportion of their capital and income, while what little is left of their revenues commands only a fraction of its one-time purchasing power. With all that—though the item of revenue from taxes in the latest budget provides for an estimated increase from 2,500,000,000 marks before the War to approximately 30,000,000,000 marks per annum—a government deficit of some 60,000,000,000 marks still stares them in the face, which is being met by constantly printing more notes and treasury bills. Their ships, their colonies, the bulk of their foreign investments, about two-thirds of their ore mines, and about one-third of their coal are gone; a scarcity of coal has laid many industries idle and keeps the people freezing in houses which the rich have to share with the poor; their country is disorganized through foreign occupation and internal troubles,

[1] A prominent New York paper recently carried a report from its Paris correspondent to the effect that the French were disappointed that the Germans did not pay. As a matter of fact, they have paid the Allies in kind some twenty billion gold marks, and they are paying every month two million tons of coal, amounting approximately to $30,000,000 per month. We have lost all sense of proportion if we do not realize the importance of these payments. It is sufficient to realize that $360,000,000 a year (that is some 30 billions in paper marks) is equal to approximately one-third of our pre-war budget. When we bear in mind what an effort it has been for France to pay off $150,000,000 of the loan which fell due in October, though she still has command over a large volume of foreign securities owned by her nationals and though she has colonies, steamers, and credit, while Germany has been stripped of all of these, it becomes clear enough that Germany is making very substantial payments at this time. Indeed, a close study of existing conditions may raise some doubts as to her ability to do much more, for, after all, it must be borne in mind that her government must always find ways and means to raise by taxation the equivalent of the coal that she surrenders every year, and it is this side of the problem that requires the most thorough examination. We gain some insight into the significance of these facts when we read the recent statement of the German minister of finance, that in order to pay for foreign securities and properties, ships, and other material so far turned over to the Allies (included in the above 20 billion gold marks paid in kind), the government had to incur a debt of approximately 131 billion paper marks!

their military protection against riots and insurrections is totally insufficient and unreliable. How, on top of that, are they to pay fabulous indemnities and avoid bankruptcy and social disorder? With all the powers of a dictator, one would not know how to solve such a problem, and if any financier among the Allies or the neutrals can show how it can be done, he should promptly step forward and give the world the benefit of his advice.

The danger of such a situation is that, if driven to desperation, even the sanest population might in the end surrender to the argument of the reactionary to the effect that, if all hope for a brighter future is to be abandoned, it might be better to open the doors to Bolshevism, in spite of its horrors, which then would engulf all Europe and give Germany a chance to start again on a level with her unforgiving victorious enemies.

This is a dark picture, though I have not touched upon many aspects of the case that might have added to its gloom. However, there are silver linings to the clouds, hopeful elements, to which we may cling.

If I compare the impressions formed during my visit to Europe last year with those I have gained this year, I cannot deny that progress has been made, even though it is a source of keen disapointment that it has been so slow. Last year, upon my return, I stated that the most important thing to be done was to "prick the bubbles of false hopes and illusions"; that people, collectively and individually, would have to learn to live within their incomes and stop relying on further foreign assistance or on covering their deficiencies by continued recourse to government printing presses. I added then that the world's most determined efforts would have to lie in the direction of deflating ideas along with price levels, but that the real cure would come only through the pressure of hard necessity and suffering. It may amuse the reader to remember that last year these statements were novel. To-day this is obvious and trite, and that in itself we may regard as a tremendous step in advance. Last year it took courage and vision on the part of leaders of thought and finance in England, on the continent, and in the United States, publicly to subscribe to a memorial that expressed similar ideas and recommended that countries should be placed in a position to issue loans secured by first liens on certain revenues, and that no country should be loaded down with financial burdens beyond its maximum capacity of taxation. But in the face of promises made by governments to the effect that the enemy would be made to pay for the entire cost of the War, it was believed impossible at that time to make the public submit to such advanced views.

To-day we see labor reconciled and strongly committed to this conservative course, and we find the Brussels International Conference unanimously endorsing practically every principle and recommendation of the memorial—except that it was not permitted by the League of Nations to discuss the question of the indemnity. One witty member of the Conference is reported to have said that it reminded him of a doctor's consultation with a proviso that the physicians would be permitted to look at the patient's tongue but not to examine his heart or lungs. While between the lines of several reports it could plainly be read that the Brussels committees would have had no difficulty in adopting the views of labor and of the memorialists with respect to the indemnity, it must be stated with sincere regret that in the face of the gravest economic disturbances and human suffering it took a full year to call together the leaders of finance, and that when they finally convened, they had to submit to such a restriction.

The remarks of the American "unofficial observer," Mr. Boyden, were refreshing in these circumstances. Not being an invited member of the Brussels Conference, he felt, apparently, that he was not forbidden to express his mind. He said that in his opinion American men of affairs did not consider Europe a good business risk until it had settled its quarrels and the conqueror should meet the vanquished half way. These remarks called forth unfriendly comment in some European countries and, as usual, the American press did not stand by the man who represented the United States in a foreign controversy. But can there be any doubt that Mr. Boyden was right? Hundreds of our men have gone abroad in order to study European conditions and with the eager desire to do business. The tangible results so far (even though the floating credits granted through thousands of individual transactions are estimated to amount to three and a half billion dollars) have been comparatively unimportant. If America really had full confidence in Europe, dollar exchange would not sell at so extraordinary a premium in the strongest countries of the Old World.

The economic disturbance caused by the War will not be fully overcome until surplus food and surplus raw materials existing in some countries meet the empty stomachs and idle hands existing in others. Given reasonably steady social and economic conditions, the surplus of goods will travel to meet unemployed and hungry people abroad; that is, capital will emigrate for a temporary or permanent stay in foreign lands. If, however, social and economic, that is credit conditions are permitted to sink so low that capital dares no longer undertake the venture, then idle hands and empty stomachs —as far as they survive and are capable of doing so—will emigrate in order to meet the surplus of raw materials. The failure to make a real peace, the fatal procrastination in reaching a condition of finality, is gradually tipping the scales toward the crude and cruel method of a settlement by the flow of people rather than the flow of capital. The sooner we arrest the destruction of wealth and credit in Europe, the sooner shall we stem the threatening tide of European emigration which, if permitted to become an avalanche, will prove a grave menace to the Old as well as to the New World.

Europe is at the crossroads of her destiny, and the decision whether she will sink or rise lies largely in the hands of France. In contemplating the present plight of France and Germany, I am led to compare poor France, with her devastated regions, to a man maimed in the War, showing the stump of a limb shot to pieces in the struggle. Germany, on the other hand, economically ruined, may be likened to a man infected to the core with tuberculosis, hopelessly doomed to death unless the disease is arrested but, to the casual observer, showing no outward signs of the dread malady. Can the poor French invalid expect to regain his strength by a transfusion of blood from so wretched a body? There are those in France who take the moderate and wise view that if Europe with her present form of social order and civilization is to survive, countries must cease to carry on a war after peace, that they must stand together in removing the wreckage and in trying to salvage what can still be saved. Such men are at one with England and Italy in wishing the indemnity question settled promptly and on a reasonable basis. As against this school of thought, there are the "bitter enders," who partly from hatred engendered by the War and partly from fear—both easily understood—say that Germany must be so loaded down with debts and deprived of her coal to such a degree that she will never be able to recuperate. This would imply the reduction of a 60,000,000 people to 40,000,000 by "peaceful penetration, "which is a polite expression for starvation, the ravages of disease, and wholesale emigration. The difficulty of such a course is that a country so completely ruined would be a bad debtor for France to have. Furthermore, social upheavals in Germany might prove contagious. Finally, as soon as the effect of such a course were fully understood, neither Europe, nor we, nor the majority of the French people—particularly the working classes—would tolerate it. I do not believe that the world wants to shoulder the responsibility of seeing the fate of Austria duplicated. My own feeling is that the moderate elements in France are bound to prevail ultimately; her financial and economic difficulties and her genuine anxieties are, however, so real and so grave that it is most difficult for her to reach that conclusion.

Victorious Germany, under the leadership of her militarists, overreached herself in 1871 and thereby created a condition which led ultimately to the catastrophe of 1914. She overreached herself again at Brest Litovsk and Bucharest. Poland did the same when attacking Russia, and Russia committed a similar blunder when attempting to overplay her victory before Warsaw. The friends of France should help her to avoid the pitfalls of a similar course. I hope that Hegel's saying, "We learn from history, that men never learn anything from history," will not again prove true. No fair-minded person would deny that France is entitled to the most complete military protection against the risk of a military attack by Germany, and that she is entitled to special consideration for her industries crippled by the destruction of war and to as large an indemnity as the German nation can possibly pay, but it is obvious that France stands to lose what she is fairly entitled to unless Germany is given a chance to work and become reasonably prosperous. France, suffering, magnanimous, and wise, will enjoy the sympathy and active support of all the world. The opposite course, it is to be feared, will lead to a rift in the Entente and a continuation of uncertainty, intrigue, and destruction, which Europe is in no condition to stand and survive.

Men in all countries I visited asked me the question: "Do you believe that the United States is permanently through with Europe, or will you again take an interest in our affairs?" My answer was that America, indeed, seemed somewhat tired of participation in European matters; that a generous impulse had led the American people into a fight entered by them mainly for an unselfish and ideal motive, a fight for the respect of right, a war against war. The Peace Treaty and the subsequent developments had relegated to the background these larger issues to which we had committed ourselves. To have made this supreme effort and then to drop out would, to my mind, in the long run, satisfy America as little as it would Europe. In some form or other, I felt confident that America would come back into the fold, and if, by her hesitation, she should ultimately be instrumental in making the Treaty and the League more compatible with her ideals and original conceptions, it might possibly compensate the world for the disappointments and hardships caused by her failure promptly to ratify the Peace Treaty.

I asked them to be patient with us until after the election, and I cited to them our experience with monetary reform. I reminded them how the Aldrich Plan had failed because, at that time, a Republican President had lost control of a Congress ruled by a Democratic majority; how the Democrats in their platform damned this plan and any central banking system; and how, once in full power, the National Reserve Association was evolved, not to say camouflaged, by them into the Federal Reserve System, improved in some parts, weakened in others, but carrying into effect the basic idea of the original plan. I told them that I believed, both platforms to the contrary notwithstanding, that if the Democrats should win, the Treaty would be ratified with substantial reservations, and that if the Republicans came in, as I thought they would and should, the rôles would be reversed and they would devise some modified association of nations to take the place of the Wilson League in its present objectionable form. I felt confident that we would show in no uncertain manner that we recognize our duties toward the world as a whole and that we would find ways and means to perform them to the limit—provided Europe made it possible for us.

If there is any merit in the thoughts that have been expressed, it is obvious that exchanges and prices will not steady down to old or new levels, and that production will not get up full steam, until the indemnity question is satisfactorily disposed of. For Europe's prosperity depends upon a free exchange of goods among her nations.

In the question of foreign exchange, which is uppermost in everybody's mind across the Atlantic, all Europe considers itself as one unit matched against the United States. While there are those in Europe who fear the growing strength of the dollar and envy and blame us for being "hoggish," there are others who congratulate themselves and us because we have been able to come back to the gold standard and, by subjecting ourselves to its strait-jacket, have managed to put the brakes on further unlimited banking expansion and to make a successful start in deflation. They feel the healthy effect of our policy in the uncomfortable rise of the dollar, which registers the difference between their condition of inflation and ours, and thus indirectly applies the brakes to them, and they hope that in due time they, too, may be able to follow our lead. Meanwhile they realize that we must deflate faster than they, because, unless our prices recede, the high rate commanded by the dollar would debar them from buying any substantial measure of our goods.

On the whole, it must be the policy of European countries to buy as little as possible from us and as much as possible from one another. For strong European countries, however, (primarily for England) this has involved the difficulty that selling to weak European peoples means placing goods largely on long-term credit, while for most of the raw materials we exact cash. This means that the weaker countries have been permitted adversely to affect the exchanges of the stronger, and this movement has been further accentuated by the fact that the stronger European countries have invested billions in the weaker ones, often buying the latters' most treasured properties for a "song," owing to the bankruptcy prices of the exchanges of some of the broken-down nations.

The financial policies of England, France, and some of the neutrals have, of necessity, involved a corresponding loan and currency expansion, a higher rate of exchange for the dollar. There is seen a willingness on the part of these countries to submit to a corresponding rise in the cost of living for the present in order to secure for the future the undoubted benefit to be derived from foreign investments. From what I could gather, however, British financiers feel that they have gone about as far on the road of banking expansion as they can safely afford to go, and I should not be at all surprised to see London follow a more energetic plan of fighting further loan expansion. Ultimately, such policy, if applied, is likely to lead in Europe to greater unemployment, enforced reduction of prices, and a greater willingness on the part of labor to increase production. We may thus live to see an adjustment of prices brought about at the cost of acute suffering, because we proved incapable of effecting it through voluntary efforts to curb extravagance and speculation, and to increase production and saving, and because we floundered and failed in getting the world back promptly on a genuine peace footing.

The danger of the course now to be envisaged is that a period of acute unemployment may be contemplated without alarm only in countries where it is not likely to cause violent political and social unrest.

We all know the cruel sufferings and the social unrest that follow in the wake of a prolonged, unreasonable, and unhealthy increase of prices. For six years the consumer has been trying in vain to catch up with the rising cost of living, while the producer and trader have had their innings. We have now entered upon a period when the producer and trader will have to try to catch up with falling prices, and when the consumer—particularly the person with small fixed income—will come back more nearly into his own. As the rise was painful, so must be the fall. To have been the first to arrest this crazy and destructive rise of prices before it took still graver forms, is a real contribution on the part of the United States, for which the world owes us a debt of gratitude, even though our farmers and producers may find it hard to reconcile themselves to that view. I think we are most fortunate at this time in having a Secretary of the Treasury and a Governor of the Federal Reserve Board who are courageous and conscientious enough to disregard the political point of view and to hold to the course that clearly is best for the country, even though it may be unpopular and subject them to bitter and unfair attacks.

If there is common accord, now endorsed by the Brussels Conference, that no single great government scheme can be found to bring relief, then hundreds of thousands of individual transactions—large and small—must ultimately build the bridge across the ocean. As long as things are dark and puzzling in Europe, the scope of each individual effort—no matter how ambitiously it may be planned—will probably remain within moderate limits. With banks extended to capacity on both sides of the Atlantic, there is no use blinking the fact that to-day we are rapidly nearing a dangerous *impasse*, which can be removed only if hope and confidence are restored in Europe. As the Old World settles down, as the clouds lift, our participation is bound to grow in importance. For when that time comes, we cannot be content to live in snug affluence while the rest of the world suffers want. Human lives and the progress of humanity will then prove more valuable than a few points more or less in the strength of our banking reserves.

There are certain things, however, which even to-day we cannot afford to neglect, unless, indeed, we are resigned to appear to the world as hopelessly selfish or inefficient. I must confess that I felt shocked and humiliated when bankers in London told me that at this time shippers in foreign lands were abandoning the use of American bankers' acceptance credits and turning again by preference to the use of English credit facilities. They also told me that American acceptances were "melted" in London (that is, rediscounted there), and they asked, in all sincerity, whether there was any discount market at all in the United States outside of the Federal reserve banks. Think what it means that with approximately equal discount rates (ours being lower at present than the London rate), our dollar acceptances should go for discount to London and our credits should not be used or not be available at a time when the dollar in the world markets sells at a premium of over 25 per cent above the pound sterling, and when the natural preference of a would-be drawer should be to use acceptance credits in the country whose exchanges are highest and fluctuate the least. "Something is rotten in the State of Denmark," and we must make haste to cure these conditions, fair neither to ourselves nor to England, which is very anxious to see us assume our proper share of the burden of financing the trade of the world. If, with all the odds in our favor, we cannot now put dollar exchange on the map, we might just as well give up our hopes and ambitions for America to become a world banker.

A French banker said to me: "Has it occurred to you that in the future, whenever we shall have an acute international political crisis, we are likely to have a financial panic?" I asked him what he meant, and he said that the policy adopted by some countries with respect to the treatment of private property was certain to have that effect. "Suppose," he said, "as an illustration, that there should arise a critical disagreement between England and France, the bankers of both countries would at once begin to withdraw their mutual balances and securities for fear of confiscation in case of war. That would undoubtedly, in every case, precipitate a panic." I believe our bankers ought carefully to study this very serious question. We have nothing to gain and much to lose by joining in a policy of disregarding the rights of private property. We shall probably, in the course of time, become the largest owners of foreign securities and properties, which would become endangered in case we were drawn into any war. To me, however, it is of greater interest that nothing be done that might stand in the way of making the United States the gold-reserve country of the world. Bank balances here and bills on the United States ought to become the favorite reserve investment for all the world, and in order to become that, there must not be any vestige of a doubt as to their safety in times of peace as well as of war. It may be interesting to note that the Transvaal Parliament has decided to indemnify enemy owners of confiscated property by offering them the equivalent in Transvaal bonds, so that there is an important precedent that we might follow. Let us bear in mind that from the small seeds of thoughtless blunders have grown the big catastrophes that have shaken the world.

Exchanges cannot be rehabilitated by the magic touch of large loans. It is the degree of productivity of a country and its fiscal policy that will ultimately determine the level on which prices and foreign exchanges may become stabilized. Increased productivity and a stern fiscal policy cannot thrive, however, except where there is peace, where there is hope and a willingness to respect law and order. A constructive peace between estranged nations and classes must be our first goal. As we succeed in reaching it, and I firmly believe we still can, the financial and economic problems will solve themselves one by one. If we miss this aim, if the rudder slips from constructive hands, no one can tell how far into uncharted seas our craft may drift.

DECEMBER 1, 1921

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PRESIDENT'S ANNUAL ADDRESS BEFORE THE AMERICAN ACCEPTANCE COUNCIL

WE must frankly admit that in the year under review the headway made in the work of the American Acceptance Council has, of necessity, been less marked than in previous years. This is but natural; for successful promotion of the American acceptance business is not possible during a period of stagnation of world trade.

After the failure of a beautiful impulse to bring a lasting peace to an embattled Europe, Uncle Sam—like Achilles—withdrew sulkingly into his tent, disheartened and discouraged, and fooling himself into the belief that he could find peace and prosperity in "splendid isolation" while chaos might engulf the rest of the world.

We have since learned our lesson. It is true that the United States, more easily than any other nation, could live as a self-contained country. But it would mean that we would have to reduce our output to the limit of our own consumption; in other words, that we could work our fields, our mines, and factories to only a part of their capacities. It would mean prolonged unemployment and receiverships, of which we have already witnessed a painful beginning.

We must look upon the world, with its many nations, as upon a huge manufacturing plant composed of many separate units of machinery, each exercising a different function, indispensable for the completion of the final product. These units are connected by transmission belts, to which we might liken the foreign exchanges. If we destroy important units of the machinery, the finished article cannot be produced, and the entire factory is disorganized. But it would be useless to fool with the transmission belts; we would first have to repair the broken piece of machinery.

I cannot help smiling whenever I hear of ingenious plans, which are conceived as independent devices for the purpose of bringing about a "stabilization of exchanges." It is true that the world cannot hope to return to fairly normal economic conditions until the exchanges of the principal countries are stabilized. That stabilization, however, will follow the restoration of economic order; it cannot precede it. It is not necessary, or indeed practicable, for the majority of the countries involved to aspire to return to the ante-bellum level of exchanges. But their aim must be to find a level on which they may successfully arrest the further inroads of the enemy, whose deadly weapon is the printing press that night and day manufactures government obligations and currency.

When we succeed in bringing these printing presses to a halt, we will have gained the strategic point from which we can successfully carry the rest of the enemy's positions. It is generally admitted to-day that, in order to stop printing presses, budgets must first be balanced. It is equally well understood that taxation cannot be raised beyond certain limits without defeating its own ends, and that, therefore, the main efforts in attempting to balance budgets must be directed toward retrenching expenditures.

From these points of view it is of the greatest possible moment that Uncle Sam, having once more come out of his tent, is manfully trying to induce the leading powers to cut down their most wasteful expenditures. No student of history will doubt that, unless these efforts succeed, the world is doomed to suffer a setback from which it will not recover for generations. But while reduction of armaments is an indispensable prerequisite, it can only be considered as a first, though the most important, step. It must be followed, if world disaster is to be avoided, by a modification of the reparation terms, so that Germany may be enabled to carry them into effect, without being forced to continue the fantastic output of her printing presses.

It admits of no doubt that Germany's present course must lead to financial and social chaos in Central Europe within an ominously short time. People who see evidences of strength in Germany's industrial activity and in the "boom" prevailing on her stock markets are like those who mistake the hectic flush on the cheeks of a consumptive for an indication of health and vigor. Unless one would consider it a sign of prosperity that in Russia a railroad ticket sells for a million rubles, and in Austria a woman's dress for a hundred thousand crowns, one could only see the dread symptoms of a panic in the amazing rise of foreign exchanges and shares in German markets. It means that people, inside of Germany and out, have reached the definite conclusion that so long as that country is held to pay in gold so much more than she possibly can produce in goods, or induce the world to accept in goods, the Reichsmark is doomed to decline—and will be thrown overboard—and "things" in Germany (or the equity in things like industrial stocks) and foreign exchanges are bound to rise and will be bought. Increased dividends, payable in worthless paper, in most cases, do not give the German holder the same return in goods that he enjoyed before the War. As long as from one day to the other prices of goods and wages jump in this hectic manner, there is no power on earth that could produce a balanced budget and stop the continuous and unbounded increase of the national debt and circulation. Under such conditions the classes that used to live on fixed incomes, are ceasing to exist and the working classes are doomed continuously to struggle for increases in wages so as to enable them to catch up with the ever-rising cost of living.

While every new decline of the Reichsmark has flooded Germany with manufacturing orders, it is true, none the less, that her total exports have not sufficed to meet the cost of all her importations. Exchange fluctuations during the last months have shown such ghastly proportions and have created such uncertainty, that to-day many German exporters no longer dare take foreign orders. As a consequence, German export trade during recent months shows a very marked decline. One dreads to think what may be the consequences when factories will have to be closed. Acute unemployment in a country of over 60 million people, protected by an army of 100,000 boys, is a condition not to be faced with complacency.

Meanwhile, disorganization in one of Europe's important units affects the others. Wherever one goes—in Switzerland, Holland, Scandinavia, and England—one finds conditions very similar to ours; factories working at half their capacities, or not at all, accumulations of unsold goods, frozen credits, and extended banks trying to liquidate their loans. It is significant that in almost all these countries we find some wiseacres or politicians propounding the doctrine, that it is the monetary system or the banking policy of the particular country that is to be blamed for the loss and suffering. In almost every country there are some who hold the view that, in order to meet the low cost of production of German goods, their own governments ought likewise to indulge in inflation. Whenever I heard such arguments, which happily are spending their force, I had to think of a man in good health who, advisedly, would attempt to become infected by a person afflicted with scarlet fever, because he envies him the auto ride to the hospital—or to the cemetery.

Stronger nations cannot cure their ills by sinking to the level of the weaker ones. They must rather seek salvation in arresting the inflationist's plunge into financial anarchy, so that his lower standard of living may not ultimately drag down their own.

In the United States we have been fortunate in having been able to keep intact the solid foundation and gigantic strength of our monetary and banking system. Through an early return to the gold standard, and by subjecting ourselves to its strait-jacket, we forced ourselves to arrest the mad rise of prices, and the world owes us a debt of gratitude for having acted, and for acting to-day, as the anchor that holds the ship from drifting further away from a safe course.

In spite of its critics the Federal Reserve System has proved itself a tower of strength. It is impossible to imagine the losses and agonies the country might have had to undergo without the protection of the Federal reserve banks.

The time is close at hand when all sections of the country will clearly see how deeply they are indebted to the men who were charged with the administration of our great banking system for having courageously withstood the vicious attacks of those who wanted to force them into unsound and half-baked schemes for the purpose of granting hasty and artificial relief; cures which, in the long run, might have proved worse than the disease. Plans to guarantee deposits, plans to keep foreign exchanges at par (as a special function to be exercised by the Federal Reserve Board), plans to stabilize prices (when they had reached their highest points), plans to bring Liberty bonds back to par by having the Federal reserve banks carry them at nominal interest rates, plans to finance the War by straightforward inflation, or to use cheap money rates—before they were warranted by intrinsic conditions—for the purpose of currying favor with certain sections of the country, and similar plans of ignorant or selfish amateurs or schemers have since proved their utter folly.

Since the termination of the War the Board on the whole has stuck to the sound principle of permitting economic forces to reassert themselves as early as possible and to have them shape the country's course rather than to resort to artificial palliatives that would only delay the ultimate healing process, no matter how much they might appeal to the clamor of the crowd. To-day the country is the stronger for these courageous policies of its leaders; and as a result we are moving back to a lower range of interest rates and a higher level for government securities which are solidly based on the strong underpinning of the real and unadulterated economic conditions of our country. They rest on liquidation successfully accomplished rather than on feet of clay.

It is significant and logical that we should now have become the leaders in this downward trend of money rates, and that England has been closely following in our wake. Her bank rate is slightly higher than ours, which would seem natural; her open-market rates are slightly lower than ours, which would seem slightly anomalous.

The call-loan market for acceptances—the most vital prerequisite for the development of a world's discount market—shows a remarkable growth in strength and scope, largely due to the intelligent and consistent policy of the New York Federal Reserve Bank. There still remains much work to be done, however, if we wish to secure for our open discount market the wide range that, in the long run, it must possess. Our Acceptance Council may well continue to devote its particular attention to this phase. England seems about to return to her earlier system of bi-weekly stock exchange settlements, and we should not fail to continue our own efforts in similar directions.

It must be our aim, whenever we safely can do so, to place our vast banking strength freely at the disposal of other countries; this is but fair to the rest of the world and to ourselves.

The gap between the dollar and the currencies of the rest of the world has become unhealthily wide, but it is not within our power to bridge it unaided. It is only when the credit of the Old World is restored that, automatically, our unused loaning power will become effectively available for world trade and development.

Europe's credit, however, will not be restored as long as political and economic strife continues in the Old World; as long as the will to destroy is stronger than the wish to construct, and as long as wasteful armaments consume the savings of the people.

Europe will have to remove these obstructions before America can do her full share in the work of reconstruction without which our own peace and prosperity cannot be assured.

If I were to translate America's position with regard to the economic problems of Europe into plain business language, I should say: we are substantial creditors of the Old World Corporation, which is our best customer and which is facing great financial difficulties. Is it to our interest to let this corporation go into insolvency and disintegration, or shall we encourage and further a reorganization? The answer is plain. But how far we may be able or willing to go in taking "new securities" or even in paying an assessment (that is what contribution we would make towards rehabilitating our customer) that depends on the plan of reorganization and the confidence it will inspire.

JANUARY 18, 1922

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BARKING UP THE WRONG TREE

An Address Delivered Before the Merchants' Club of Boston, Massachusetts

One cannot stay abroad for several months, observing Europe with American eyes and looking at America as she appears from the other side of the water, without becoming deeply impressed with the fact that not only has the structure of the world, as an organic, political, and economic edifice, caved in, but that, after more than three years of peace, no common plan has as yet been devised for its ultimate reconstruction. Some of the world's walls were only cracked on the surface and needed nothing more than a solid dose of whitewash and paint. That was our case. In England, the cracks are deeper, but the wall stands and bids fair to become adequately reconditioned, even though some strong buttressing will be necessary. When completed, the structure will bear a surprisingly modern appearance, and in the treatment of the color scheme there will be noticed a liberal use of green. In France, some parts of the wall were badly shot to pieces and are being rebuilt, but the rest of the structure and the foundation are fairly unimpaired, even though there has been delay and confusion in agreeing on architects and plans. In Germany, the wall itself looks outwardly intact, but the foundation has been so badly undermined that unless a thorough underpinning is promptly provided, the entire structure is in danger of caving in.

In Russia, both walls and foundation are gone.

The more deeply one studies the situation, the more one becomes convinced that all these walls will have to be rebuilt before the whole world will prove once more a reasonably satisfactory dwelling place. Indeed, if it is to be moderately comfortable, at least England, France, Germany, and the United States will have to reconstruct their parts of the structure and agree upon a common roof. In that case, one might hope that, with a temporary wooden partition in the East, we might be able to get along for a while, even though it will always remain a drafty, incomplete, and unsatisfactory building until the Russian wing has been restored.

I have been to Europe three times since the Armistice and each visit has left me in a more depressed state of mind. It is true that physically conditions over there are much improved, that greater order prevails, and that the trend away from Bolshevism appears conclusive. But it is heartbreaking to think that as early as 1919 leading minds on both sides of the Atlantic united in warning the world of the impending collapse of exchanges and the subsequent losses and sufferings if armaments were not reduced, if budgets remained unbalanced, if printing presses continued to work overtime, and if indemnities were imposed or enforced in excess of the measure of practical execution. It is heartbreaking to think that nevertheless mankind could not be saved from wading through these last three years of waste and misery.

Assuming that the turn for the better is now at last near at hand, we still must wonder why it was possible or necessary, that for so long a period every country should have pottered with its own wall, stealing the other fellow's bricks, interfering with or even pulling down the neighbor's work, without even considering that no roof could be put up or real shelter provided, until all had completed their share of the structure. Why was it that truths—that were as plain then as they are to-day—could not then assert their power over the minds of the masses? Why is it that even to-day their progress is so desperately slow? War psychology alone does not furnish an adequate explanation. The truth of the matter is that party politics all the world over robbed the masses of the very possibility of getting at the facts and of assessing them at their proper worth.

It is easier to destroy than to construct. In the work of destruction and under the stress of a life and death struggle, the peoples of democratic countries were willing to sacrifice some of their individual rights and privileges and to give almost autocratic powers to their leaders. For the vastly more difficult work, however, of world reconstruction it has, unfortunately, proved impossible to secure the same unselfish subordination to a common aim. As soon as the danger was over, all countries returned to a condition where petty party interests and selfish personal ambitions once more became supreme. How to remain in power, how to attract votes, became the outstanding thought of the men in charge of governments; how to oust these men, the dominant aim of their opponents. The pains of mankind were relegated to the second rank. The fate of parties became more important than the fate of millions of suffering people; and billions of treasure were sacrificed to this childish game. During the long months of the struggle, we often wondered how the world could financially and economically endure another year of the horrors and waste of the War. Since the Armistice we have often wondered how it could survive another year of this kind of peace.

In discussing their difficulties with European leaders of finance and business, one becomes deeply impressed with the gravity of the problems of each nation and with the sincerity of these people when they explain their desperate plights. During the four months of my stay abroad I was haunted all the time, however, by the hopelessness of arousing these countries to the larger point of view of dealing with the problems as an all embracing one, and by the realization that, unless they would rise to such a point of view, unless they would cease to look upon the world confusion from a purely national or local angle and through the glasses of party politics—the white race would be doomed to a long period of retrogression and adversity. Historians will find it hard to explain to future generations what lasting advantage intelligent political leaders could have expected from continuing to feed the masses with misconceptions and lies which sooner or later were bound to explode and consequently to increase only the indignation of the people at having their sufferings needlessly prolonged. We clearly see to-day, and British leaders freely admit, that England, and the world with her, would have escaped a loss running into billions of dollars if, in order to gain an election, Lloyd George had not pounced upon the doctrine that Germany should pay for the War, a doctrine from which afterwards it took him three wasteful years to wean the British people. Meanwhile, this doctrine had crept into the Versailles Treaty, as the basis of the very economic clauses which have since become a menace to England's commercial existence, and which she is trying so desperately to undo to-day. A brilliant writer put it tersely a few days ago when he said: "Lloyd George won an election by the promise to make Germany pay, and he is planning now to win a new election by preventing Germany from paying."

In a similar way France's credit has suffered, and her progress and recovery have been delayed by inveigling the French masses into the belief that Germany's annual payments could be measured, not by her ability to pay, but by French budgetary requirements. France's statesmen knew better. They knew quite well that if the maximum export capacity ever shown by a factory has been ten billion gold marks per annum, it could not possibly continue for any length of time to secure a margin of profit large enough, to produce on that gross business, an annual surplus of over four billion gold marks to be presented on a silver platter to its foreign stockholders or creditors. But that myth has been kept alive for the benefit of the French voter, just as much as our politicians persist in telling their constituents that France and Italy, or our smaller debtors in the Balkans, will be able to pay back what they owe us. Such elementary questions as to how these debts could possibly be paid without ruining both creditor and debtor, were glibly shoved aside. Reiteration and make-believe indignation drowned the attempts of reason and logic to make themselves heard. The masses were kept blinded so effectively that it has now become a most difficult task—to use Maynard Keynes' expression —"to debamboozle" them, when at last the politicians begin to realize that the time has come when it would be almost good business to tell them the truth.

Where imagination failed, where minds balked at grasping in advance the inevitable consequences of the course pursued, bitter experience has proved a more successful taskmaster.

When taxation had exhausted its possibilities, when the speeding up of note-printing presses remained the alternative, when factories closed down and people were choking with products of their farms in one part of the world and starving in the other, the time had come at last when the discussion of reduction of armaments could be taken up with some success, and when financiers could confer on the economic ills of the world with some hope of practical results. The sudden collapse of the Cannes Conference illustrates strikingly how desperately difficult the return to sanity has become. Nevertheless, we must cling to the belief that this dramatic intermezzo will prove to have involved only a temporary setback. World psychology is coming back to a more normal state and no single country may venture to block for any length of time the determined onmarch of reason. It was at this momentous juncture that there was born unto Uncle Sam a new child, called the "Agricultural Bloc."

It is nothing less than a national disaster that the birth of this combination of proponents of provincialism and class interests should have occured just at the time when in our national policy a world point of view is required. These men have not hesitated to preach to the farmer the theory of a self-contained America; they profess to believe that the United States can be prosperous with all the rest of the world going to pieces; and they would let it go to pieces without lifting a hand. Apart from protective measures designed to serve their special interests, they see the most promising cure for our ills in easy money. Accordingly, they hold that restriction of credit and high money rates are principally responsible for the past sufferings of the farmer and are incensed, therefore, at the banks in general and the Federal Reserve System in particular. One would have more sympathy with their point of view if their proposed remedies were likely to help at least their own bailiwicks. But what their constituents would gain if the policies of these men prevailed, is about what England gained from the so-called "khaki election." We, too, would require wasteful years to "debamboozle" our people and to find our way back from the swamps into which these men would lead us.

There are now before Congress some thirty bills and amendments to the Federal Reserve Act designed to secure for agriculture easier or ampler credit facilities from, or a better control over, the Federal Reserve System. One bill proposes to throw open to the public all meetings of the Federal Reserve Board; another fixes the maximum rate for all agricultural loans of the Federal reserve banks at 4 per cent; another, which is now being debated on the floor of the Senate, would make it obligatory upon the President to fill the next vacancy occuring on the Board by appointing a professional farmer.

Only a few days ago I returned from a trip to Washington where the Advisory Council of the Federal Reserve Board, representing all parts of the country, submitted to the President a memorial dealing with this attempt to convert a non-partisan judicial board into one dominated by class interest and political pressure.

In this memorial we have dealt at length with the fallacy involved in trying to fasten on the discount policy of the Federal Reserve Board the responsibility for the desperate condition in which, unfortunately, the American farmer finds himself to-day. It would be "carrying coals to Newcastle" to tell a group of Boston business men that we need only look across the Canadian border, where there is no "vicious" Federal Reserve Board, in order to see that wheat took there the same plunge downward as with us (and as it did in Argentina). Boston people also know that our wool producers, in spite of their difficulties, were better off than those of Argentina or Australia. Boston bankers are, furthermore, aware of the fact that commodity prices began to fall many months before loan contraction became effective, and that good or bad crops and increased or decreased consumption affect the price of cotton to a far greater degree than high or low rates of money. Any unbiased student knows that world phenomena were at play, whose power extended far beyond those of central banks in general and the Federal Reserve Board in particular.

The War had driven commodity prices to dizzy heights and over-stimulated production to its top notch. During the War, people—individually or collectively, of their own free will or through force of circumstances—had reduced their purchases to a minimum. As a consequence, the Armistice ushered in a world-wide orgy of buying, and prices continued to soar while financing by easy government credit and wholesale inflation continued unabated. Then the day of reckoning came. Some governments had printed obligations and currency so recklessly that they began to perceive that their purchasing power i. e., their credit, was rapidly vanishing, or, indeed, had already ceased to exist. Other governments awoke to the realization that, if they wished to escape a similar fate, it was high time for them to bring their printing presses to a halt. Simultaneously the stampede for goods began to subside; the outraged consumer began to strike, while the work of forty million men returned from war to peace work began to tell; and the world turned into a buyers' market with the same excessive vehemence with which, before, it had surrendered to the domination of the seller. Psychology appears to have been the same all over the world. In most countries producers had not sold out as long as the boom lasted, but had accumulated their wares in the expectation of a further rise. When the crash came farmers were heavy borrowers, while prices of commodities, which constituted the collateral of their loans, were shrinking, and while the farmers themselves were precipitating further declines through the preparation of the next crop. The general collapse of prices hit not only the farmer but all industries. But while factories and mines can be shut down and the output reduced, for the millions of individual farmers scattered all over the world voluntary curtailment of production already begun is impossible. Unless nature intervenes, or the funds give out, a new crop will be gathered, irrespective of whether or not the previous one has been marketed.

This made the suffering of the farmer particularly acute. If blame attaches to the Board it is for having applied the brakes too late and for not having brought the mad orgy of speculation to an earlier end, thus shortening the height from which the final fateful plunge was to come. But the ultimate collapse was inevitable, with the Federal Reserve System, or without. Economic laws were asserting themselves all around the globe with unmerciful grip—the pendulum had swung too far and it had to swing back.

It is of the greatest importance that there remain no vestige of a doubt in our minds that if our staples have backed up on our hands to-day, and if their prices have shrunk in many cases even below their cost of production, this is principally due not to high money rates or an over-severe restriction of credits, but much rather to the fact that the power of consumption of many foreign countries has been so crippled, their credit so impaired, their exchanges so demoralized, and their standard of living so lowered that, as the inevitable result, a world-wide stagnation of trade had to ensue. Our goods will again begin to move freely when the world-wide wasteful government expenditures for armaments are reduced, when budgets are balanced, and a practical method is found to establish actual economic peace in Europe.

If time permitted, it would be most interesting to show how closely interlocked are the economic problems of all countries; how impossible it is to bring order into the economic chaos of Europe, unless, for instance, ways and means are found to prevent the Reichsmark from sinking to the level of the Austrian crown, and how, again, this problem is closely interlocked with the one of bringing the load of the German indemnity within the scope of practical fulfillment. Until the indemnity question is properly settled, Europe will remain afire. Until the flames are extinguished and the smoke subsides, and until we can make a careful survey of the ruins, it is idle to talk about plans of stabilization and financial reconstruction. It is tempting to discuss the many side issues involved in this problem, but it is perhaps more timely to devote our attention to-night to the clouds overhanging the future of the Federal Reserve System. Suffice it to say that England and we have the most vital interest in seeing economic chaos avoided in Germany. If we can raise the standard of living, and therewith the consumptive power of Europe, our goods will move and it may be possible to find our own new level of prices without a further drastic cut in wages. It is obvious that the inverse development, i. e., a further lowering of the standard of living in Europe, and a further decrease in her consumptive power, must have the effect of further accentuating and prolonging the accumulation of goods in the large producing countries of the world, and of affecting their own standard of living and wages. Our "Agricultural Bloc" leaders are, therefore, "barking up the wrong tree" when they, as good farmers, try to make the Federal Reserve Board the "goat." Indeed, the shoe is on the other foot.

Central banks, in war times, cease to function as effective regulators, as they do in times of peace. But central banks do not create the ebb and the tide; at best, they act as dams, preventing the very extremes of flood and drought.

The major causes and effects were world-wide, as we have seen; only the minor currents—and these only to a certain extent—could be guided or controlled by the Federal Reserve Board.

It is charged that, within these limitations of its powers, the Board stopped inflation too late and pushed deflation too far. But the Board could well point to the fact that if these charges were true they would primarily lie against Congress itself and against the Treasury.

It was quite natural that, since the beginning of the War, the government's policy, as expressed through Congress and the Treasury, dominated the would-be business point of view of the officials of the Federal Reserve System. If inflation went as far as it did and lasted longer than should have been permitted, and if, as a consequence, prices rose higher and banks extended further than was in the interests of the country, it was largely due to the fact that, against expert advice on the part of Board members and others, Congress had decided to finance the War on an artificially low interest basis, that for its post-war financing the Treasury still insisted on easy money, and that, as a consequence, Federal reserve banks found themselves committed, until long after the conclusion of the Armistice, to carry all these war issues at low rates. These, in turn, affected the general money rate structure and the credit atmosphere of the entire country. Even though it is a matter of sincere regret that the Board did not find ways and means to emancipate itself sooner from the money policy of the government, it must be admitted that it was a very difficult step for them to take, one that required a great deal of valor and involved enormous responsibilities. When, finally, after previous warnings—which business, agriculture, and finance had ignored—the banking conditions became so critical that the Board was forced to intervene, it had to act with great severity if, indeed, we were to avoid a period of bank failures of the worst kind, instead of an era of consistent and quiet loan liquidation.

If, during this period, mistakes were made on the part of some of the Federal reserve banks, certain organic defects of the Federal Reserve System are not entirely without blame for these regrettable occurrences. The Federal Reserve System received a fateful blow when the Organization Committee, decided to cut it into twelve districts, some of which are purely agricultural and in themselves, therefore, ill-adapted to function as self-contained reserve districts. It is obvious that districts, which are "all grain" or "all cotton," are bound to be drawn upon too simultaneously and too extensively by all their banks, so that the reserve power of these districts is bound to exhaust itself more quickly than that of districts which comprise more varied industries. These districts are, therefore, in a cramped position and can call upon the assistance of other Federal reserve banks only through the somewhat cumbersome method of rediscounting with them through the intermediary of the Federal Reserve Board. While this is a perfectly legitimate means of meeting seasonal demands and one of the most essential features of the Federal Reserve Act, resorting to it creates in the Federal reserve banks the uncomfortable feeling of over-extension and dependence upon others, of which they try to rid themselves as fast as possible. This, in turn, quite naturally, engenders a tendency on the part of Federal reserve banks in such districts, to lean back and seek the protection of higher discount rates sooner than would be necessary if they were part and parcel of a larger and more varied district. These difficulties were pointed out to the framers of the Act and to the Organization Committee; they were also warned that for the Board it would become a very much more difficult task to direct these rediscount operations and generally to supervise their conduct of business with twelve Federal reserve banks, than it would be with a smaller number. In addition, however, smaller reserve districts make for smaller men. The provincial point of view is bound to prevail and the national and international perspectives are bound to be lacking. A predominance of a one-sided view or of class interest is much more to be apprehended in small districts than in larger ones, in which they have a much better chance to offset one another. It is quite safe to say that with larger and fewer districts it is unlikely that some of the errors would have occurred in the application of the so-called progressive discount rates, which created so much irritation in agricultural sections.

The weakness caused by dividing the System into too many component parts is accentuated by dividing the control on top. The Federal Reserve Board, although nominally responsible, and, therefore, the principle target of attacks, is not entirely master in its own house. The Treasury always has two votes and under a very vicious provision of the Federal Reserve Act retained its powers to deal direct with the banks of the country with regard to Treasury deposits. Moreover, the function of examining national banks remained in the hands of the Comptroller of the Currency. It is true the Federal Reserve Act gives power to the Federal Reserve Board to make examinations of its own. But it is only too natural that the Board has hesitated to embark upon the thoroughly wasteful enterprise of organizing and paying for an army of examiners, who would duplicate the work done by the staff of the Comptroller. On the other hand, as matters are to-day, the power to examine and to wind up banks lies with the Comptroller, whereas the power to keep these banks going lies with the Federal reserve banks. In many cases mismanagement and losses might have been avoided if bank examinations had been carried out under the supervision of the Board, or of the Federal reserve banks, so that the latter would have been fully and promptly advised at all times where member banks became over-extended or involved in undesirable transactions. In the past, examiners were trained to report primarily to the Comptroller and to make secret reports to him, which would be given to the Federal reserve banks only upon the latter's specific request, thus causing dangerous red tape and delay, whereas it would have been most essential to choke whatever was wrong in its earliest beginning.

As things had drifted, it was difficult to gauge the proper moment to abandon a stern policy of liquidation in the face of the critically over-extended conditions in which many banks still found themselves. We should, therefore, have it clearly in mind that for these organic defects, as well as for the consequences of a discount policy forced upon the Board, the Treasury and Congress are directly responsible, and instead of being the accusers, it is they who ought to be placed in the dock.

It would be child's play to explode the malicious slander that unscrupulous demagogues or ambitious politicians have spread about the administration of the Federal Reserve System. But it would be wasting your time and abusing your patience. It is a very serious matter, however, that the minds of the masses are systematically poisoned by the wilful distortions and criminal lies which are used as the material for these campaigns. Grave harm results for the United States because misguided public opinion not only leads to mistaken steps detrimental to the public interest, but in addition, stands squarely in the way of truly helpful action, which can only be hoped for when the underlying facts are properly and generally understood. Permit me to deal first with this latter phase, viz., the helpful and constructive course that might be pursued at this time.

It would lead too far to discuss what might be done to remedy the fundamental organic defects which I have indicated. Their analysis indicates in itself the lines on which some day relief may be sought. But immediate helpful action may be undertaken in another direction to which both the Federal Advisory Council of the Federal Reserve Board and the Congressional Commission of Agricultural Inquiry have drawn attention.

There is no doubt that the farmer suffers from the fact that he is served almost exclusively by small banks. The credit of these institutions is quickly exhausted, and the majority of them, approximately 20,000, are small state banks, which are not members of the System, and have, therefore, no *direct* access to its credit facilities. It is a perfectly sound idea to develop the Federal land banks, or some similar organization which would supplement them, to a position of adequate strength, and to authorize these Federal land banks to rediscount with the Federal reserve banks such agricultural paper (with maturities up to six months) as any member bank may rediscount with them to-day as "eligible paper." In this manner, without going into further details, an outstanding weakness of our present system could be overcome and the resources of the Federal reserve banks be made more directly and more readily available for legitimate agricultural demands, without sacrificing any of the sound principles to which the Federal Reserve System must cling with the utmost tenacity.

Another opportunity for helpful action lies in an entirely different direction. We have seen that world-wide trade stagnation is the cardinal root of our farmers' sufferings. It is obvious that, in so far as we assist in eliminating the causes of this stagnation, we render the most effective aid to our agricultural interests. In that regard, the Washington Conference, in spite of all the difficulties it has met, is promising the first tangible results since the conclusion of the Versailles Treaty. The Cannes Conference took up the Washington cue in a manner that awakened our keenest expectations, and in spite of the unfortunate turn it took through Briand's sudden resignation, we still must hope that England and France will succeed in agreeing upon a formula which will assure peace and return to prosperity in Europe. Whether we shall be able, however, to reap the benefit of the Washington Conference will depend, to a large extent, upon the power of Congress to overcome the threatened resistance of our own obstructionists, many of whom pose as the protectors of the farmer, while, as a matter of fact, their narrow conceptions make them his greatest enemies. The slogan has been developed by these men that to show a spirit of generosity in dealing with the debts of our associates in the War would be "playing Wall Street's game." The truth of the matter is that stagnation in the United States means easy money, and easy money means a strong bond market, and rising bond prices mean that capital would be recouping the billions that were lost when these prices fell to abnormally low levels. But it is the farmer who probably would profit more than any other class in the United States if we could reëstablish an economically stabilized Europe, a Europe with which, once more, we could do business on a broad scale. It would mean prosperity for him, bought at the price of surrendering, or scaling down, some pretty doubtful claims which, sooner or later, we shall find that we shall never be able to collect. By that time, however, we would find that our trump cards have lost the value they have to-day. It is obvious that we should not surrender or abate these claims until we see that, as a prerequisite, the conditions are fulfilled which make for the economic stabilization of Europe. But it is necessary that the farmer and his friends in Congress should understand that whatever we may do in this regard is primarily to his interest in a much larger measure than to that of Wall Street.

As against the helpful and constructive policies as here outlined, let us see what the course pursued by the "Agricultural Bloc" would do. If the bill as introduced in the Senate were enacted, it would first have the very serious effect that the

President, when the next vacancy occurs, would have to appoint a professional farmer and could not reappoint Governor Harding, whose term then expires. The entire country owes Governor Harding a deep debt of gratitude for the unselfish service he has rendered and for having been willing to endure a wave of unfair criticism and vicious attacks, particularly from the cotton-growing sections, where he himself originates. It would have been far easier and more agreeable for him to comply with the wishes of his Southern friends, and it was only the highest sense of duty that made him pursue that course which, after earnest deliberation, he and his colleagues considered as being in the interests of the entire country. He has proved himself a fearless and loyal servant of the people, and with equal loyalty they ought to rally to his support.

It is almost humorous to point to the fact that the two banking members of the Federal Reserve Board come from Alabama and Minnesota, two purely agricultural sections; that, of the remaining three members, one is a professor of economics from California, one a lawyer from Boston, and the third a newspaper owner from Poughkeepsie. And it is to such a Board, which does not contain a single representative from dreaded New York or Chicago, that for the protection of agriculture it is thought fair and necessary to add a professional farmer!

If a farmer is put on the Board to represent his profession, the question will at once be raised, why should not representation of labor, or business, or manufactures, or of any other interest, be claimed with equal justification. In that case, we might, in the end, see a Board composed of quite a large number of members, each of whom would be expected to represent a special interest, instead of having a Board which would seek to the best of its ability to avoid being swayed by the demands of any particular group. Moreover, is it not obvious, if politics is permitted to exert pressure and hound members in this way, that the Board, as a politically independent power, will be destroyed. If service on the Board were to become so distasteful and humiliating that men of real worth would no longer consent to accept membership on it, there is no doubt that within a comparatively short time the best men serving to-day as officers in the Federal reserve banks would become disheartened and leave the System. The latter would then rapidly become the domain of mediocre men and political job seekers. It does not admit of any doubt that unless the people rise and state in no uncertain voice that they will not permit the dragging of the Federal Reserve System into politics, the System, from the great blessing it is to-day, is bound to become the greatest curse, and that it will develop into the biggest political machine the country ever had—a national "Tammany Hall"—corrupting the country from top to bottom. The history of the first and second "Bank of the United States" in that case will be certain to repeat itself. It is a question of the old Latin saying: "Principiis obsta," which freely translated, means, "Watch the entering wedge." I am amazed at the indifference that, so far, has been shown by the country in this matter. Attacks have been heaped upon the men administering the Federal reserve banks. Unscrupulous demagogues have spared neither time nor money in carrying on a determined and slanderous propaganda, while the people and the press have, so far, not taken up the cudgels in defense of a system which has rendered the greatest possible service to the country during the War and has been of almost equal benefit to it in liquidating the War's aftermath. Without that protection by the System, the country would have become the prey of the worst panic it ever witnessed.

And yet, unless the people of the United States exercise constant vigilance, politics is bound inevitably to creep into the System. The politician will always wish to please his constituents. The constituents will always be unreasonable in their demands upon the politician, and selfish requests upon the Federal Reserve Board and upon the Federal reserve banks for favors of one sort or another will, therefore, always have to be expected. If those in charge of the Federal reserve banks resist such demands because granting them would not be in the interests of the country at large, there will ever be plenty of food for animosity on the part of Congress against the Federal Reserve System. The Federal Reserve System can only expect to succeed in keeping itself clean if, on the one hand, it can count upon the wholehearted protection of whoever, from time to time, fills the presidential chair at the White House and, on the other hand, upon the unwavering active support of the people.

And now, in conclusion, what are you and I going to do about it? Some of my friends say: "Don't waste your time, the Federal Reserve System will be drawn into politics sooner or later, as sure as fate, and you won't be able to prevent it." Those are the same faint hearts that told me fourteen years ago, that we would never be able to get a central banking system. We secured it all the same; but we did not win it without a hard concerted effort and not without a comprehensive and well-planned campaign of education. It should be easier to preserve the System than it was to originate it; for in the pioneer work we were alone, with ninety-nine and three-quarter million people out of one hundred million against us, and nothing but an appeal to the imagination to draw upon as our ammunition. Now the majority of the people are with us and we are supported by actual achievements that speak for themselves.

Nevertheless, because the Federal Reserve System, at times, must do the painful things (wholesome, but unpleasant, like some of the measures that "stick" in our memory as the most "striking" impressions in our early education), and because to attack the money power will always be a popular cry with the masses, I agree with my faint-hearted friends: "The Federal Reserve System *will* be dragged into politics"—unless we organize and fight such attempts. At present we talk about the necessity of organizing only whenever the System has become endangered, and when it is too late. Just as much as labor and the farmer have permanently organized for the protection of their interests, so business ought to build up (and preserve) an organization with the single aim of forcing sound business principles upon the government, and of keeping politics out of business, and particularly out of the Federal Reserve System. An organization of this kind might comprise all who are interested in improving government standards and efficiency, such as, for instance, the adoption in actual operation, not only in theory, of a national budget system. It is unpleasant business to waste one's time on the mudslingers, yet it is dangerous to permit them to carry on unhampered and uncontradicted their business of poisoning the people's minds. True facts are not nearly so catching and do not penetrate as far as sensational charges, yet the country will be saved an enormous amount of suffering and actual losses, if we concentrate our efforts, more than in the past, on having the true facts better understood. Since its early beginning, the Federal Reserve System has been exposed to dangerous attacks from the farming sections, and it will not be safe from them until we have erected a strong organization that will effectively respond to the farmers' legitimate requirements and, at the same time, will stand the brunt of their onslaughts in case unreasonable demands are made. Such a buffer organization would serve to ward off dangerous political pressure from the Federal Reserve System and enable it to carry out its functions without compromising its sound principles or its independence. In addition, however, a consistent campaign of education should be carried on which would tell the people what the Federal Reserve System does for them, and how desperately important it is for them to keep it clean and inviolate. If politicians will sense that any political party attacking the integrity of the System must fear to be wiped out at the next election, they will take jolly good care to keep their hands off. It is insulting the sound common sense of our people to believe they should not be capable of understanding that the road to prosperity is more easily attainable along the lines I have sketched, than by permitting themselves to become hypnotized by the magic tunes of political snake-charmers, pretending to be able to conjure up the price of commodities by putting a farmer on the Federal Reserve Board.

Democracy becomes a dangerous form of government when units are too large and problems too complex to be easily comprehensible to the voting masses. It is under such conditions that the demagogic press and the cheap politician thrive—when they go fishing for votes or pennies, with the bait of sensational slogans and charges that catch the imagination and appeal to the passions of the people. We need an intellectual civic guard, volunteers to patrol the street and let their lanterns of truth shine into the dark corners. Owls and demagogues shun and flee from the light.

We need a "Light" brigade fighting false prophets of democracy who here and everywhere endanger the safety and impede the progress of modern commonwealths.

JANUARY, 1922

XXXVII

POLITICAL PRESSURE AND THE FUTURE OF THE FEDERAL RESERVE SYSTEM [1]

FROM the earliest beginning it was obvious that, in order to be successful, any attempt at a thorough banking reform in the United States would have to approach the subject from two angles: one, from the point of view of pure banking technique, the other, from the point of view of administration. The problem was to devise a plan carrying conviction, not only as a sound and effective piece of banking machinery, but also as offering reliable safeguards against any possibility of the control of the System passing into the hands of either "big business" or the politicians. If legislation was to be secured and, indeed, if the future of the System was to be protected, a formula had to be found by means of which these two elements would be called upon to balance one another. If the new banking system was to remain safe and sound, its administration had to be shielded from the danger of becoming subservient either to business or to politics, and, conversely, safeguards had to be provided against business or politics becoming subservient to the new banking system.

From the bare point of view of efficiency and economy, one central bank with a purely business management would undoubtedly have yielded the best results, but from the point of view of what was required in the larger interests of the country, of what was essential in order to prevent the System, once established, from becoming the target of ambitious business

[1] Reprinted from the Annals of the Academy of Political and Social Science, Vol. XCIX, January, 1922. Adequate treatment of this subject would require more time and study than was possible under the circumstances and more space than could be given in this volume.

men or scheming politicians, maximum efficiency had to be subordinated to maximum safety.

The writer's original plan, "A United Reserve Bank of the United States," proceeded on these lines; so did, subsequently, the Aldrich "National Reserve Association of the United States" and, later on, the Federal Reserve Plan. Each of these schemes followed the lines of merging the country's dead gold reserves into one live organization; of building upon this more or less centralized gold an elastic note issue; and having thus centralized the scattered forces of the nation into one organic structure, of once more decentralizing its administration and organization, and circumscribing it far enough to prevent the dangers of abuse of power and of one-sided control.

The advocates of a pure central bank had to reconcile themselves to a lower banking ideal by surrendering to the political requirements of the case. Conversely, the sworn antagonists of a central banking system had to surrender their political ideal, the gospel of decentralized banking, in order to provide a system that would be workable as a banking proposition.

Thus the Democrats, starting with the thought of a large number of disconnected reserve banks, ended in tieing them together into a central banking system, in its essential features not very dissimilar (though differing in many important details) from the Aldrich Plan, which had started at the other end.

Disregarding the question of which side made the largest share of valuable contributions and mistakes, and dealing with the topic simply from the point of view of sincere appreciation of the banking system which we enjoy to-day, the problem now before us is to examine what remains to be done in order to promote and protect its future.

A study of four years from within the System and of almost four years from without, leads me to think that its gravest danger lies in the gradual ascendency of political influence.

The Federal Reserve System, as such, is based upon the perfectly sound theory of placing the actual management of the Federal reserve banks in the hands of boards of directors, the majority of whom are appointed by business men. The direction of the System as a whole, on the other hand, its policies and its supervision, are vested in the Federal Reserve Board, which consists of five members appointed by the President and confirmed by the Senate. These members are appointed for ten-year terms and the governor and vice-governor are designated by the President and serve at his pleasure. The Secretary of the Treasury and the Comptroller of the Currency are members *ex officio*. The Secretary of the Treasury is chairman of the Board.

Among the many Presidents, secretaries of the treasury, senators, congressmen and comptrollers of the currency that I have known, there have been good ones and bad ones, some admirably strong and some lamentably weak. And therein lies the danger for the future: As long as there are two *ex officio* members of the Board, who are constantly subjected to political presure; as long as every President has the power to play favorites with Board members by promoting them to the positions of governor or vice governor or demoting them at will; as long as one or two members may be vulnerable because their terms are about to expire, it can readily be seen how easy and therefore tempting it is for the political members to assert their influence, and how unpleasant and unenviable may be the lot of members struggling to preserve their independence and self-respect.

When members of the Board are hounded by senators or congressmen because they do not think it proper to flood the country with easy money, just because elections are coming; or when they refuse to believe that excessive fluctuations in foreign exchanges during the War were due to Wall Street speculation and could be regulated or controlled by the Federal Reserve Board; or when they are viciously criticised because they will not accede to the belief that fake easy money can counteract the effects of overproduction of important staples when a period of reduced world consumption is encountered—it is, at best, not easy to find men of importance willing to make the material sacrifices involved in service on the Federal Reserve Board.

It will become increasingly hopeless, however, to secure such men unless some of the defects in the organization of the Board as above described are promptly removed and the dignity and independence of the office of Board member are enhanced. To state it briefly: The governor and vice governor ought to be elected by the Board itself; or they should serve in rotation, and the office of the secretary of the Board might, in the latter case, develop into something like an office of a "general manager," or the governor ought to be designated for the full term of his membership. The governor ought to be the chairman of the Board and, instead of the Secretary of the Treasury, who hardly ever has the time to attend Board meetings, the Undersecretary of the Treasury ought to become an *ex officio* member of the Board. There should be an additional member of the Board, who should exercise the main functions now resting with the Comptroller of the Currency. The vast powers now vested in the Comptroller are the remnants of an undemocratic, antiquated, and dangerous system. Moreover, the present condition has led in the past to costly delays, duplication of work, inefficiency, and unbearable irritation. Examinations and rulings concerning banking operations ought to be made by one body and not by two, if a prompt and efficient administration is to be assured. In the past, Board members often have had to wait upon the good graces—or bad graces—of the Comptroller before any headway could be made in important matters. The situation bristled with humiliating and distasteful incidents. It seems ridiculous that the Board should have appeared before Congress with one set of recommendations and the Comptroller, a Board member, with another, often entirely in conflict with the policies of the Board.

Unless the Federal Reserve Board is raised to a position of the greatest possible dignity, and men of real strength, independence, and knowledge are found to serve on it in the future, it is to be feared that the System will become the football of politics. A splendid instrument of protection might thus become an element of dangerous disturbance.

This danger is all the more real because of the unfortunate action of the Organization Committee in establishing twelve Federal reserve banks instead of beginning with eight, as the Federal Reserve Act had permitted them to do.

The larger the number of Federal reserve banks and the greater the consequent decentralization, the more important becomes the Federal Reserve Board as the sole organic link connecting them all. The weaker the single districts and the more disconnected they are, the more difficult, and at times desperate, becomes the task of the Federal Reserve Board to coax or club these autonomous units into prompt and effective coöperation. The Board was planned to be pre-eminently a supervisory and directive body; excessive decentralization was bound to force it more and more into the exercise of administrative functions, which—for men located at Washington, unable to be in personal close touch with actual business conditions and operations in twelve separate and remote districts —naturally became more bewildering and troublesome than was advisable or necessary.

The fundamental thought of reserve banking is that the idle money of one industry or section should become available for the seasonal requirements of another. Federal reserve districts, therefore, which are "all cotton" or "all grain" were from the beginning doomed to fail as independent districts; seasonal requirements were bound to exhaust their loaning power too rapidly. While they could secure assistance through the somewhat clumsy procedure of rediscounting with other Federal reserve banks under the direction of the Federal Reserve Board, they generally would be inclined to hesitate to resort to these rediscount operations, inasmuch as they would tend to emphasize the organic weakness or temporary exhaustion of their districts. Unfortunately the Organization Committee disregarded this fundamental principle and the district of St. Louis, for instance, and its surrounding Federal reserve districts were delineated with about the same regard for economic questions as were Austria and her so-called Succession States at Versailles. Owing to this absence of a sufficient diversification of interests and minds, local banking factions and self-centered provincialism have from the beginning played too large a part in forming the boards of directors, the managements, and policies of many of the twelve Federal reserve banks, with little understanding of the national questions involved. Much bitter feeling and criticism was caused, particularly in the agricultural sections, by unnecessary and irritating mistakes made in fixing interest charges or applying ill-advised methods of administration. Whatever anticipatory words or warning in this regard were given to Congress and later to the Organization Committee, unfortunately, have proved only too true, including the prophecy that an excessive number of Federal reserve banks would prevent the establishment outside of New York of large financial centers, where important open discount markets could develop.

It is a great loss for the country that at the time of the formulation of the law and the establishment of the System it was impossible to convince the sections involved that a Federal reserve branch bank could convey the same benefit as a Federal reserve bank; indeed, that as a branch of a larger district a region would be better served than as a self-contained district. Minneapolis, as a branch of Chicago, would have been as well provided for as Detroit, but it would enjoy a rate of 5 per cent instead of its present 5½ per cent rate. The same holds good for Dallas and Atlanta.

As stated before, the weaker the Federal reserve banks, the stronger must be the Federal Reserve Board. This is all the more essential because the Board appoints the class "C" directors. The latter often constitute very important elements of safety and must be appointed, political pressure notwithstanding, solely with the view of securing the men best qualified for the protection of the banks. Finally, the future of the local management of all banks, in short, the morale of the entire System, will depend upon the character of the Federal Reserve Board.

If the Federal Reserve System was able to accomplish its phenomenal development and if it could respond so splendidly to the trying demands of the War and of the post-war period, it was largely due to the devotion, vision, and ability of members of the Federal Reserve Board and of some of the Federal reserve agents and governors of Federal reserve banks, who perfected and developed the System into the extraordinary banking organization it is to-day. Strong and exceptional men made themselves the leaders of the rest. Without them, the System would have failed. Such men to-day are still serving the System, though from the material point of view many of them could do vastly better for themselves in other fields. If politics should creep into the Board, these men will gradually drop out, and from top to bottom the System will deteriorate. If the administration of the Federal Reserve System, in Washington and in the banks, should then fall into the hands of weak and incapable men who only see "fat jobs" in the positions, instead of those who to-day devote themselves to the work at a personal sacrifice because they see in it an opportunity for public service, there are dark days ahead for the country.

Government must exercise an effective control over business in its administration of the Federal reserve banks; but this control must be exerted through a Federal Reserve Board comprising men of the highest integrity and efficiency—men who do not seek the job and would not hesitate to surrender it, if either business or politics should interfere with the independent exercise of their duties to the best advantage of the country as a whole.

If that is to be achieved, and the future of the Federal Reserve System is to be assured, the people themselves must take a hand. They must never fail to rally to the support of these faithful servants when unfairly attacked, and they must not lose any opportunity of showing them that their services are appreciated. If the people do not prove that they honor their leaders and stand by them loyally, what incentive is there for these leaders to hold out?

In a similar manner, Congress must feel that whoever dares to encroach upon the independence of the Federal Reserve System attacks the most sacred treasure of the people. In Washington I came to know many upright men of the very highest type; nevertheless a large number of our political leaders might prefer that the Federal Reserve System be subservient rather than independent. They want open doors for patronage and a ready compliance with the wishes of their constituents.

Protection for the Federal Reserve System must, therefore, not be expected from Washington, unless it is possible to arouse and strengthen the small number of distinguished men in the Administration, and in Congress, who would understand the danger and would fight to ward if off. They will win if the country makes Congress understand that its heart is in it. If the people cease to exercise vigilance, if ever they relax in their insistence upon the integrity of their banking system, it may develop, as it did before, from the greatest blessing into the gravest menace. A Federal Reserve System turned into a political octopus, a national Tammany Hall, would infest not only the counting houses but every farm and home in the country.

MAY 5, 1922

XXXVIII

DOLLAR ACCEPTANCES AND EUROPE'S FINANCIAL REHABILITATION

Address Before American Acceptance Council.

I WELCOME the privilege of being permitted to express the great pleasure that members of the American Acceptance Council feel in greeting here to-night so many distinguished guests from both the United States and abroad. We look forward with keen anticipation to the message that they will bring us. Indeed, I believe, it would be most agreeable to you, as I am sure it would be to myself, if I could end my remarks right here and give them the floor for the rest of the evening. If, however, we want to secure the full benefit of their comment and advice, I believe that it would be well that I should explain in the briefest possible manner the character of the Council's work and its methods of procedure.

In giving them a short review of our activities and ambitions, past, present, and future, I shall attempt at the same time to outline the program for our to-night's discussion. Briefly stated, the aims of our Council are as follows:

It strives to ascertain the soundest principles to be observed in making and distributing bankers' and trade acceptances; it seeks to establish a common accord concerning the best methods of translating such principles into practice with due regard for our particular needs; it carries on a consistent publicity campaign spreading the Council's doctrines:

1. Among the granters and takers of acceptance credits;
2. Among the distributors and investors in acceptances;
3. Among those who are charged with the duty of regulating and supervising our banking systems and, finally, among

the courts and attorneys, whose task it is to keep safe and solid the legal ground upon which our entire credit structure must rest.

England always has been the classic school for acceptance banking. The framers of the Aldrich Bill and of the Federal Reserve Act took the best British acceptance and discount principles and tried to transcribe them into law, and later it became the duty of the Federal Reserve Board to ascertain the best British practices and to codify them in a series of rules and regulations.

Our Acceptance Council has striven to supplement this work, acting as a connecting link between the Federal Reserve System and the banking and business communities; translating the Board's formal rulings and statements into popular language and spreading its gospel. At the same time the Council followed carefully the effect that rulings of the Board would have in practical operation, and wherever it found that the "shoe pinched," or that it seemed "too wide," information to that effect was carried to the respective banking authorities and, where indicated, remedies were suggested.

We are now in the fourth year of a consistent campaign of education on these broad lines.

The English bankers probably watched with astonishment and at times with amusement the elementary lessons we often had to teach. But we were dealing with a country entirely untrained in foreign and centralized banking and we were educating some 30,000 banks, operating without common traditions, and under elaborate State or Federal laws and supervision, as against a British centralized system of comparatively few banks, with thousands of branches, operating practically without any government supervision and legal restrictions, and governed entirely by a self-imposed code of ethics and recognized banking traditions. Moreover, we had to take into account the American temperament which after having first looked askance at American acceptance banking as a foreign and somewhat quixotic novelty and adventure, unsuited for our country—was apt to turn around "with a vengeance." As a matter of fact, acceptance bankers soon ran into the other extreme of abusing the new privilege, often extending it indiscriminately in disregard of European traditions and without proper safeguards and adequate compensation. Those trying to keep American acceptance banking developing on sound lines had to be ever alert and vigilant, applying sometimes the "accelerator" and sometimes the "emergency brakes," sometimes advocating a relaxation of rules and regulations, and sometimes advising a tightening of the grip in order to ward off abuses.

In the United States we can hardly expect ever to reach the British ideal of banking without the strait-jacket of government legislation and supervision; but it must be our aim to reduce legal restrictions to a safe minimum just as fast as the general acceptance of sound traditions, principles, and practice permits. In this regard we have just passed a milestone of historic importance in American banking evolution. After seven years of elaborate and carefully codified regulation, going into the most minute details—as was necessary in the beginning—the Board has now found it possible to follow the advice of the Federal Advisory Council and of the American Acceptance Council to liberalize its acceptance regulations and to control accepting banks, financing transactions involving importations and exportations, by the exercise of discretionary power vested in the Federal reserve banks (acting under the supervision of the Board) rather than by a volume of written detailed rulings. We have thus further approached the British model and enabled foreign users of American banking facilities to use dollar drafts with approximately the same ease as sterling credits.

Instead of reducing the scope of our activities, this recent development has enlarged the Acceptance Council's opportunities for useful service. If the Federal Reserve Board's new policy is to prove a success, the banking community must show that it has thoroughly assimilated the broad principles established in these seven years and that it is capable of developing its own standards and traditions. It must also prove that friendly advice given by the Federal reserve banks will be as readily followed as iron-clad regulations and rules of law. To have these new conditions fully understood all over the country, to advise all districts concerning views or wishes expressed by Federal reserve banks, to keep them posted with regard to new questions and the methods suggested or adopted for their solution, will be a most essential function of the Council.

The Acceptance Council is coöperating so closely with the Federal reserve banks that it can be of the greatest assistance in spreading the doctrines and views with which they wish to see the banking fraternity imbued.

There are two wards, however, over whose growth and development the American Acceptance Council has undertaken to watch: the bankers' acceptance and the trade acceptance. The latter, as a consequence of the overshadowing part played by government finance during these last years, has become a somewhat neglected orphan at the hands of the Federal reserve banks, and the time seems to have come when a determined effort should be made to secure for this poor child a proper place in the sun. Just as much as education had far enough advanced to permit the liberalization of bankers' acceptance regulations, so the problem of trade acceptances is now well enough understood in order to warrant the Federal Reserve Board to permit the Federal reserve banks to *buy in the open market* trade acceptances bearing a third name as endorsement, such as is required by Federal reserve banks when purchasing bankers' acceptances under Section 14.

After going through a process of thorough liquidation, our strong member banks are avoiding as far as possible appearing as borrowers from Federal reserve banks; it is all the more important for them to have paper that they can sell in the open market, thus being able to draw on the resources of the Federal Reserve System without appearing as borrowers. Federal reserve banks, on the other hand, if they want to preserve their power to influence the money market, must have a field where of their own will they can enter or whence they can withdraw. Through purchases in the open market or through liquidation of their portfolios of bills bought, Federal reserve banks can influence the money market better than through any other means. When member banks borrow through rediscount operations, there is no initiative on the part of the Federal reserve banks. The latter are largely "penny-in-the-slot machines" in this regard, unless, indeed, they feel that drastic action is warranted against individual borrowers or the community as a whole. The wider, however, the open market for bills, the more efficient and smoother will be the working of the Federal Reserve System. At present a lack of bills in the open market has driven the Federal reserve banks into heavy investments in government certificates and short-term government obligations; it would be much healthier if they could show a large volume of "bills purchased." The foreign bill market as an investment field is closed for the time being—for obvious reasons into which it would lead too far to go to-night—but the trade acceptance market could be opened, and by doing so the Federal Reserve System would be strengthened, while, at the same time, the development of the use of the trade acceptance would be greatly encouraged. The merits of the trade acceptance are too well understood by this body, and I shall not weary you by elaborating this point.

Very important work is being done by the committees of the Council, particularly the Publicity Committee, which performs its duties with extraordinary devotion. I shall call for reports from only two committees to-night. The one is the Letter of Credit Committee, which has been perfecting its task of standardizing and codifying the terminology used in letters of credits and credit instruments connected therewith. The other is the Stock Exchange Term Settlement Committee, which is hammering away at the problem of preparing for general discussion a practicable scheme for the substitution of a system of term-settlement dealings for our present cash dealings on the stock exchange.

Just now the world is as full of conferences, present and prospective, as it is of troubles. No single conference will be able to devise a "cure all" for our ills. A thousand steps will have to be taken in removing obstacles and rebuilding bridges before we shall find our way out of the present wilderness, and the more these steps lead back to individual initiative and away from artificial measures, the more rapid will be our progress and the more solid our ground for permanent improvement. Every conference will do some good in this regard; even those that appear to fail in producing any constructive measure will prove useful in laying bare the topography which, after all, must be thoroughly understood before we can begin to build. That Uncle Sam will at last be represented at some of these conferences and take an active part in their deliberations, is a most promising and cheering thought for those of us who believe that America has a duty to perform and that the world was not created to consist of air-tight compartments, in some of which men might thrive and feast, while their fellow-neighbors might suffer or starve in others. Japan, half a century ago, was the prototype of a "self-contained country." We remember with pride that it was America that "opened her up," as we call it. We think with a smile of the "Heathen Chinee," who, in ages gone by, built a gigantic wall, which should protect the Manchu empire and separate it from the rest of the world. I wonder how we would look to the historian, if the views of those were finally to prevail, who believe that we could live and progress and be happy as a so-called "self-contained country," that we could hide behind a wall which would keep out foreign goods and foreign people, and that from the shelter of this dam we could continue to flood a distressed world with our excess production and—into the bargain—collect our debts from it! But that is another story.

In its process of convalescence the world will reach the turning point when the force of economic thought will have conquered the sway of the political point of view. While, in some respects, things appear to look darker than ever, there is no doubt that the forward march of economic thought has been very marked and determined and that in the end we may confidently expect it to prove irresistible.

We are apt to overlook progress made under the discouraging impression of the many needless and wasteful delays that impede an immediate final advance. We have to look back into complete darkness whence we begin to emerge in order to remember that we need no longer dread bolshevism as a social menace endangering the world, that unnatural obstructions in the way of trade are fast crumbling, and that all sorts of wild theories are making room again for old sound and traditional thinking.

In this healthy development the much maligned conferences have played a most helpful, if not a decisive rôle. One of the outstanding results has been the fairly complete elimination of plans urging the emancipation of the world from the domination of gold as the ultimate basis of our monetary systems, schemes which were so much in evidence not long ago.

The stronger the world's will to return to the gold basis, the more inevitable will be America's duty to coöperate in devising plans that would bring her unduly vast accumulation of gold into a position of wider service.

In this connection I believe that among the thousand steps forward, which I mentioned before, at least one will be taken with the assistance of the American bankers' acceptance. When the proper moment comes—and how we wish it were soon!—and some of the strongest European countries will be ready to return to their ante-bellum, or a modified system of free gold payments, we may, in my personal opinion—find it timely to go before Congress and ask for an amendment which, for a certain number of years, would give the Federal Reserve Board the power to permit member banks to accept finance drafts drawn by banks of countries completing their fiscal and financial rehabilitation. Just as much as, before the creation of the Federal Reserve System, British bankers granted large acceptance credits to syndicates of American bankers in times when excessive gold exports threatened our country, so we ought to be placed in a position where we can offer the services of American banking syndicates in order to strengthen and protect European countries striving to return to an unadulterated gold standard. It is unnecessary for me to repeat that this would be only one of many other steps and one of the final ones, safely to be taken only after the fulfillment of a number of preliminary requirements, with which we are all fully familiar.

But whether I be right or wrong in this assumption, there cannot be any doubt that in the financing of a re-convalescing world, American acceptance credits will play an important part and that, therefore,—in spite of the present lull—we must not relax our efforts to further develop and perfect our acceptance methods and facilities and to consistently broaden our discount markets. The further we advance in this regard the clearer will it become to all that a world-wide reliable discount market will prove the keystone of our entire banking structure.

The main burden of financing the world will rest on England and the United States. It will not be a question of crowding out one another; the burdens will be so heavy that both countries will be grateful for having a partner shouldering a substantial share of the load. . . .

JULY 31, 1922

XXXIX

THE REHABILITATION OF EUROPE

Opening Remarks as Chairman at Round-Table Discussion at Institute of Politics, Williams College, Williamstown, Mass.

IT is a great privilege to be called upon to preside over a round-table discussion by these earnest and distinguished experts and students. All honors, however, carry with them a corresponding measure of responsibilities and, therefore, he who sits in this chair faces a trying task and one that is all the more perplexing because the subject to be considered, "The Rehabilitation of Europe," opens up a field as wide as the African deserts and as full of impasses, thorns, swamps, and snakes as the tropical forests of South America. I am frank to admit that, in these circumstances, I hesitated for a time before accepting the invitation to act as one of the guides of the expedition; and, indeed, I would not have ventured to serve at all had I not been convinced that most of its members did not really require a leader, and that much rather might they be relied upon to help me to pilot the party on its slippery path. It is the duty of the leaders, however, to fit the compass and chart the course, and this they have tried to accomplish in a preliminary meeting.

In order to clarify the problem, they have first asked themselves the question: What are we to understand by the term "rehabilitation," and what by the term "Europe"?

To begin with the second question.

We believe it will be well for the purpose of our discussion to agree upon having the term "Europe" mean Europe minus Russia. The Russian problem is unfortunately so hopelessly involved that, if we wish to grapple with it at all, we must needs attack it as a separate, independent topic at the end of our program, except where indirectly it touches our general subject or some particular phase of that subject. No matter how deeply we may regret it, we cannot escape the conclusion that steps towards the rehabilitation of the rest of Europe cannot wait for Russia's return to a condition of reasonable normalcy, or anything approaching it.

It is obvious that as long as Russia remains in a state of prostration the rehabilitation of the rest of Europe and, indeed, of the world, will remain incomplete. And that brings us back to the first question, namely, what for the purpose of our discussion we should understand by the term "rehabilitation." It cannot mean Europe's complete return to social, economic, or financial conditions such as those which prevailed before the War. To my mind, we must be satisfied with a much more modest interpretation. I think we come nearer to defining our problem if we express it by the question: How can the further decomposition of Europe be arrested? In other words, how can Europe attain the first stages of political, social, economic, and financial stability?

How far ultimately "rehabilitation" will progress, and how fast it will proceed, is a question which may be reserved for future consideration. Our immediate concern must be to consider how we can reach a truly solid foundation and escape the quicksands which threaten to swallow us at present.

The problem of "rehabilitation," as thus defined, must be considered from the two aspects of results to be secured, first, by measures that in themselves and independently are helpful and constructive, and, second, by measures constructive, only in that they destroy, or counteract, the effects of destructive and harmful actions committed in the past or still at work.

Frequently, during the earlier discussions of the problem, it was not recognized clearly enough that the purely constructive work in its most important phases could not be undertaken until some of the most pernicious influences of destructive work had been eliminated. Thus, ever since the conclusion of the Peace of Versailles, the public at large has been led to believe that financial stabilization—so indispensable for the return of sound economic conditions—could and should be brought about by huge international banks regulating exchanges, or issuing a world currency, or by large international loans; and that the United States, in particular, should play a decisive part in this regard. Ambitious plans towards these ends were launched from time to time by political and financial leaders and stimulated the people's expectations at home and abroad. All the keener was their disappointment and resentment when, one after another, these schemes failed to materialize.

It is better understood to-day that internal organic troubles must be cured before external remedies can be applied with success; in other words, that loans for purposes of stabilization cannot be placed on a comprehensive scale, and that they cannot serve any permanently constructive purpose, unless at the same time the underlying conditions are straightened out. No sane architect would put a new roof upon a building without first underpinning a thoroughly rotten foundation. He would be all the more reluctant to tackle the job if the owners frankly objected to seeing the crumbling houses of their neighbors put in order, and if they could not be brought to realize that they themselves were bound to become submerged in the general wreckage if the adjoining party walls were not prevented from caving in. It is hard to see how even the most willing minds can escape the conclusion that economic and social rehabilitation in Europe is predicated upon the reëstablishment of orderly and more normal internal and international political relations, and upon the removal of some of the most flagrant artificial impediments that now block the way.

While, with its many ramifications, the question reserved for our round-table discussions thus has the advantage of opening up an almost unlimited range of interesting topics, it presents at the same time the distinct disadvantage of raising a problem so closely interlocked, that views, conclusions, and suggestions concerning each phase can only be developed upon certain preliminary assumptions. And these assumptions, in many cases, will again be of a character that will relegate us to the modest rôle of expressing fond hopes and wishes, while the ultimate fate would rest helplessly in the hands of all too powerful—or all too powerless—politicians. But that must not discourage us. Even though we know that, since 1919, conferences of experts of the highest authority have over and over again discussed our problem and, with insignificant variations, have always reached the same general conclusions without being able to arrest the continuous progress of Europe's decomposition, it is true none the less that, under the growing pressure of inevitable economic consequences, the breach through which truth and reason will enter is constantly widening. We must not be reluctant, therefore, in our discussions, to restate things already convincingly expressed by others. Reiteration of facts, presented courageously and without bias, is, indeed, a service of the greatest importance at this juncture. Perhaps it may be well for us in this regard to remember a paragraph written by Maynard Keynes in his preface to Section Four of his "Reconstruction in Europe" series, published in the *Manchester Guardian*. He says: "Whilst no individual can much affect events which are the resultant of innumerable particulars, nevertheless the totality of individual wills, if they can be set moving rightly, can repair the injury which another totality of wills, wrongly directed, have done."[2]

There never was a time when the world was faced with graver political, social, economic, financial, and moral issues than at present. There never was a time when clear and unafraid thinking was needed more than it is now; when public opinion governed the fate of peoples more completely than it does to-day; or when it was more thoroughly misguided and misinformed.

There never was a time when public men were offered a greater opportunity to serve their countries by speaking the truth; or when they more brazenly and in a more cowardly manner whispered the truth in private, while from the housetops and soap-boxes they told the stories that would get them votes and keep them at their political jobs.

Democracy, for whose victory millions bled and died, is being stabbed in the back by selfish political leaders; it can be saved only by enlightened and courageous public opinion.

I trust I may count on your indulgence for this seeming digression; but to me these thoughts are the very essence of the work of these round-table conferences. What we say in the confines of this room is not meant to serve as headlines for the papers; but by a frank and unbiased discussion we hope to compare, clarify, and broaden our views, and then with all the greater strength to carry our conviction—each in his own way—into the hearts and minds of others. Our distinguished guest, Mr. Lionel Curtis, recently said upon landing in the United States: "In the long run, the foreign policy of any nation is determined by public opinion. In so far as public opinion is sound, the resulting policy will be right; in so far as public opinion is wrong, the resulting policy will be wrong."

No truer, no timelier, words could have been said either to the peoples of Europe or to us.

If the present attitude of the people of the United States with regard to Europe should be permitted to become the closing chapter of the great part we played in the World War, it would be a grave injustice to our country.

Every war that can be won only by the united will and unreserved devotion of a nation must end in defeat unless it arouses the passions and emotions of the people and, at the same time, stuns the logic of cool deliberation. America rose to the call with a burst of patriotism and idealism that astonished the world. The War has been over now for almost four years; America's passions and emotions have died down but, strange to say, she has not yet been able to shake off the condition of intellectual drowsiness into which she had been stunned. From a superlative moral effort, we seem to have sunk into a subnormal condition. The Peace of Versailles and the subsequent events were a deep and shocking disappointment to the people of the United States. They appear now to be afraid lest another burst of idealism might lead them once more into new sacrifices and fresh disillusions. In self-protection, we are surrounding ourselves with a wall and moat of cynicism and selfish materialism, which are to guard us against being drawn into the snares of European diplomats, or into the battles of her implacable militarists. But plain reasoning would tell us that neither morally nor materially can we hope to find a satisfactory solution in such a state of mind. We must arouse ourselves from our present condition of intellectual coma, if we wish to do justice to our self-respect and self-interest. If plain logic tells us that in order to prosper the United States needs reasonable stability in the rest of the world; if, as every child knows, trade means exchange of goods—how do we expect to see our world commerce restored when the intention of Congress in proposing new measures is generally further to increase our inordinate power to sell and collect, even though the ultimate result of such measures would be further to weaken the ability of other nations to settle with us? Can thinking people fool themselves into the belief that billions of dollars of international debts can be paid, without inquiring by what means and with what consequences these settlements can be effected? Can any sane person believe that the standard of living in Europe can sink to deplorably low levels without affecting our own industries or standards? Or that, in such circumstances, we could build and maintain a Chinese wall that would keep out a tidal wave of European goods or, failing that, ward off a tidal wave of starving people, who would come to consume in our midst the goods that we could no longer export to them.

It is true that we are powerless to help Europe until a *modus vivendi* has been found between France and Germany; that is, until the indemnity question has been settled on a truly practicable basis. Unless that settlement can be brought about, Europe is doomed beyond hope and repair. But I cling to the belief that the day is near when France will recede from her present suicidal attitude of wanting the milk of the cow and her meat at the same time. When that day comes, our confidence in the future of Europe will begin to return, and with it our willingness to change our attitude of aloofness into one of sympathetic coöperation. In such circumstances, it would then seem inconceivable that America should continue to insist on claiming payment for war debts from such of our Allies as plainly could not repay us without disastrous consequences to themselves and to other nations, including ourselves as well. That public opinion in the United States at present is not prepared for so far-reaching a concession is no doubt true; but if France showed the proper spirit of enlightened generosity, I am profoundly convinced that our country, properly guided, would ultimately respond in the same spirit. I believe, however, that, as in the case of naval disarmament, we shall first have to reach an understanding with England about the funding and ultimate payment of her debt to us. As long as we tie the English debt, which our people may hesitate to forego, to those of our other Allies, whose debts under certain conditions clearly should be forgiven, no headway can be made.

When once the fundamental questions are properly disposed of, the subsequent economic and financial operations, bewildering as they may seem to-day, will solve themselves, one by one, in comparatively simple and natural ways; and it will not be difficult for us to play our part effectively and wholeheartedly in them, provided always that public opinion demands it, and provided also that relief does not come too late.

There remains not much time to be wasted; indeed, the avalanche is gaining speed at so terrific a rate that it is doubtful to-day whether it can be arrested in its fateful plunge. . . .

I hope that time will permit the members of the round table to dwell, in their discussions, not only upon the material, but also upon the moral side of the rehabilitation problem. The latter phase, to my mind, is of all the greater significance because, as we shall see, the moral aspect of the case has an important bearing on the practical side of the question.

It is the curse of this present generation that too many of us profess one thing, and do the other. While this is bad enough when it is true of an individual, it is fatal when it becomes characteristic of a nation as a whole. Since the Armistice, the art of breaking pledges—openly or by sophistry—has become a science. The consequence of such a condition must be either a fatal lowering of the general morale of the people—such as, unfortunately, we witness already in many countries—or a moral uprising that, in a burst of indignation, openly acknowledges errors committed—pardonable enough after the heat of the War—and undoes some of the harm, as far, at least, as it is still possible to do so. England and Italy are boldly moving in this direction; in the United States progress on these lines has been disappointingly slow. A few of our men have had the courage to speak out; but if we compare the attitude of English statesmen, English men of science and letters, and British labor with our own, we are forced to confess that it is time for us to wake up and speed up. The moral aspect of the case has a distinctly practical bearing upon the problem because, without a return, or at least a nearer approach, to what I should like to call our pre-Armistice ideals, there is small hope for the creation of an atmosphere in which anything but the rankest selfishness and materialism will govern the attitude of man to man, of class to class, and of people to people. That is not the atmosphere in which production thrives, in which people make efforts to save, or in which nations stop wasting their substance in excessive armaments. The pulpit, the cathedra in school and college, the rostrum, and the printing press offer unequalled opportunities for service at this juncture in the proper guidance of public opinion.

We must shake off our foolish and cowardly fear that actively lending a helpful hand in the salvation of Europe may dangerously entangle us and commit us to another war. To begin with: Whether we play the ostrich or not, our international finance and trade relations are such that we cannot possibly avoid being deeply involved in European affairs as, indeed, we were before the War, and are to-day. Moreover, our intervention insured the winning of the War, and determined the terms of the Armistice and, in a great measure, the map and living conditions of a new Europe. Can we, in self-respect, now smugly wash our hands of the whole affair because we are tired and disgusted? No military intervention on our part is involved or urged. We could render invaluable services, however, by permitting our "unofficial observers" to take their seats officially at the council table and to tell Congress and the people what, during four critical years, they have "observed," so that the country could at least form a clear and definite opinion based upon authoritative facts concerning the problem that confronts it. Not military operations or blockades, but only moral pressure—and, if need be, economic pressure—is what is required at this time in order to help the moderate and constructive elements to overcome the destructive and militaristic forces which, whether in power or out of power, block the path to the world's return to genuine peace and healthy prosperity. Governments could coöperate along such lines without waiting for the day when all the "i's" will be dotted and all the "t's" crossed in the instrument that will unite them in a league, or association, or whatever its name may be.

I think the term "round-table" conference was invented because it is the duty of the leader of such a discussion to put his head on the table, so that the other members may have the fun of swinging their axes and chopping it off. I have prepared my introductory remarks with this end in view, and shall cheerfully face my judges and executioners if, by offering my neck, I prove instrumental in starting a free and fruitful debate. In any case, I thank you for your courtesy and indulgence in listening to me for so long.

NOVEMBER 16, 1922

XL

UNCLE SAM'S GOLD POLICY[1]

WHEN a child knocks its head against a table it is apt to vent its resentment by spanking "the bad table." In a similar manner peoples in their earlier stages of development used to kill messengers bringing evil news, or, like the old Hebrews, they would make the "scapegoat" the carrier of their sins.

With the complacent smile of wise and superior beings we view such childish and primitive ways; but to most of us it would hardly occur that the historian will look back upon the present generation's attitude toward the problems of the War's aftermath as very much akin to that of children spanking the table.

For several years the popular mind—encouraged and misguided by political leaders—has busied itself more with finding "goats" than with searching causes and facing facts and, as in years of yore, the prophets have "cried in the wilderness."

Since the Armistice it has been one of the pet games of many countries to make their banking systems responsible for economic disturbances which follow inevitably in the wake of great wars. That in some countries the government's inflationary policy was held to have caused the very suffering which in others was laid at the door of deflation is an amusing incident which, however, did not affect the judgment of such critics. Few stopped to consider how far in each country banking systems were altogether anvils rather than hammers.

The banking and gold policy of the Federal Reserve Board has come in for its full share of blame. From two opposite

[1] Reprinted from *The Manchester Guardian Commercial*, November 16th, 1922.

sides the Federal Reserve System has been attacked in the United States; and at long range it has been fired upon from across the Atlantic.

American farmers—aided by Thomas Edison and Henry Ford, two strange bed-fellows!—have claimed that the Federal Reserve System has absorbed the country's gold and deprived the farmers and small borrowers of its use for the benefit of "international Wall Street finance." Such critics see in the vast accumulation of gold an insidious instrument of deflation breaking the prices of their products, while another school of thought attacks the Federal Reserve Board's gold policy for the very opposite reason that they view with alarm the dangerous possibilities of inflation.

European writers have charged us with having wilfully driven up the price of the dollar in other countries, of having drained the world of gold, and of keeping it hoarded in the vaults of the Federal reserve banks.

What are the facts?

If it is true that without a reasonable stability of exchanges the economic equilibrium of the world cannot be properly restored; if, furthermore, it is true that exchanges cannot be stabilized without reëstablishing a definite and freely functioning relation of currencies to gold, then we need not hide our heads for having been the first among the nations to return to an unreserved gold standard. Schemes of international currencies and dreams of monetary systems without any metallic basis are gradually dying away in the minds of serious students, and going, we trust, to their eternal resting-places.

It has been one of the outstanding results of the Genoa Conference that there now seems to exist a general and clear recognition of the fact that, in order to regain economic stability, every country in due time will have to return to a gold standard on its own individual plan and its own level. There is now a fairly common accord that, where the hawser snaps which ties the ship to the gold anchor, the entire economic craft is hopelessly set adrift. We rendered the world a distinct service, therefore, when, for once, we did not miss the opportunity that good fortune had given us, and got back to our gold anchor as early as possible. In doing so we provided a safe place of anchorage where other vessels may tie up alongside of us, as one by one they may be able to escape from a bottomless and wild sea of confusion.

This step, which it was our privilege and obvious duty to take, and a further one, presently to be discussed, constitute the fundamental elements of our active gold policy. That second measure is the adoption of the plan—embodied in the amendment of the Federal Reserve Act of June 21st, 1917, and since then carried into full effect—of withdrawing our actual gold circulation, substituting therefor Federal reserve notes, and of concentrating in the Federal reserve banks the gold so withdrawn, together with the bulk of the gold theretofore held in the vaults of the banks of the country. It is this process that, more than anything else, has called forth the charge, at home and abroad, that Uncle Sam is "hoarding" the gold of the world.

Nothing could be more unwarranted than such an imputation.

To begin with, we did not planfully set out to draw towards our shores the yellow metal belonging to the rest of the world. It was not we that needed and exacted the gold; much rather was it the predicament of other countries imperatively requiring our raw materials without having sufficient quantities of goods or securities or credit with which to settle, that forced them to dump their gold on us, no matter whether or not we wanted it, or whether or not its flow threatened us with renewed inflation.

The tide of gold reached our shores in two great waves. The first from December, 1914, to July, 1917, resulted in a net influx to the Federal Reserve System of $1,230,000,000. It was permitted to serve as the basis for a huge credit and currency expansion without which there seemed to be no possibility of effectively financing our Allies' and our own gigantic war requirements. I believe it is a fair statement to say that during that period England's policy in directing her gold exports to us was largely guided by her desire to provide our money market with a gold basis growing fast enough to keep pace with the rapidly increasing inverted pyramid on top of it. That superstructure had to be kept bulging, not only in order to provide food and ammunition for the Allied ranks, but also in order to "peg" sterling exchange in New York.

But we are no longer interested in this first wave of gold, but rather in the second, which began in April, 1920, and has not yet reached its end; it has so far resulted in a net addition to Uncle Sam's gold holdings of about $1,000,000,000. Temporarily the movement was arrested or, in any case, substantially reduced, by the strike interrupting gold mining in South Africa, and by our absorption of over $1,000,000,000 in foreign securities. It is an impressive evidence of the effective operation of our Federal Reserve System and of the soundness of our "gold policy," that no inflation has as yet resulted from this second wave of gold.[1]

While before the organization of the Federal Reserve System so vast an accretion of the yellow metal inevitably would have resulted in a redundance of money, and would, therefore, have tended to stimulate inflation, the importation of about $1,000,000,000 of gold, received by us since April, 1920, up to this time has been handled so as to avoid any inflationary effect.

Indeed, while our gold holdings showed this spectacular increase, our Federal reserve bank's deposits and circulation contracted by about $1,000,000,000, and general bank deposits and loans showed a corresponding shrinkage.

To use a simile—which in our "dry" country appeals very vividly to the imagination. If we had two tumblers of equal

[1] This article was written in June, 1922.

size filled with a mixture of wine and water up to a line representing the aggregate Federal reserve bank deposits and circulation at their highest point and at their present level respectively, we would see that the total volume of fluid went down, but that the actual quantity of wine (representing the gold) is larger in the smaller volume of liquid in the second beaker than it was in the larger contents of the first. If, however, we were to consider that forty per cent of wine and sixty per cent of water are to constitute the maximum of dilution (approximate limit of expansion of Federal Reserve deposits and circulation), we could fill up the tumbler now much further than before.

In other words, our Federal Reserve System's power of potential expansion has been increased by about $2,500,000,000, while its present liabilities, on the other hand, have decreased by about $1,000,000,000 since they reached their highest point.

Before we engage in a discussion of the all-importance of the vast reserve strength so accumulated, it may be advisable to contemplate for a moment what our position would be if we stopped "hoarding," redeemed our Federal reserve circulation, and once more filled the pockets of the people and the tills of the banks with actual gold or gold certificates.

If we reduce to its simplest form the Federal Reserve statement of May 31st, 1922, we find that in round figures there were outstanding in liabilities:—

Reserve deposits	$1,800,000,000
Federal reserve notes	2,100,000,000
	$3,900,000,000
Against which there is gold held to the amount of	$3,000,000,000

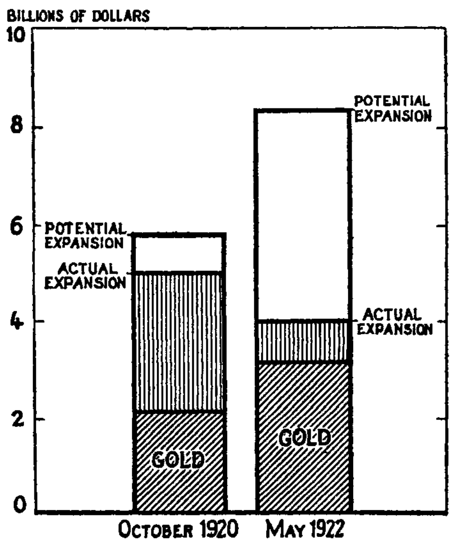
If the Federal Reserve Board wished to carry into effect the desire of those urging the reëstablishment of an actual gold circulation, it could do so overnight by a stroke of the pen. It would suffice to order the Federal reserve banks to carry a gold reserve of one hundred per cent against their outstanding

Federal reserve notes. That would in effect make every Federal reserve note a gold certificate. We should then have the following statement:—

		Deposits
Federal reserve notes	\$2,100,000,000	\$1,800,000,000
Against which gold would be held to the amounts of..........................	2,100,000,000	900,000,000

In other words, deposits would then be covered by a fifty per cent gold reserve.

If we take 35 per cent as the legal minimum cover for deposits, this would require \$630,000,000, so that about \$270,000,000 would be all that would remain available to serve as a gold cover for a potential increase in circulation and reserve deposits, or for gold exports, if such should be required.



On so weak a basis the Federal Reserve Board, beyond any doubt, would have had to take in sail a long time ago. Faced with all kinds of economic clouds at home and abroad, it could not possibly have favored the free unfolding of an era of low interest rates, enabling our markets to absorb about \$1,300,000,000 in foreign securities since January, 1921. Indeed, with such a position it is doubtful whether we could have returned to the gold standard as early as we did, or at all. It is obvious that if we had not "hoarded" our gold—so that at present, instead of a beggarly \$270,000,000, we have a free gold reserve of \$1,500,000,000 available for would-be gold exports, or as a cover for a potential increase in Federal reserve deposit or circulation liabilities—we could not have come to the assistance of the world, and thereby of our own agriculture, commerce, and trade on the imposing scale we did. It is tempting to ask the question how, with any policy other than the one adopted, it would have been possible for us to finance the gigantic requirements of the War and of the readjustment period.

It seems incredible that in the face of such facts dreamers, schemers, and demagogues should have been able to bamboozle large sections of our population into the belief that the System that saved them, and saves them to-day, should be held responsible for their ills. But a nation that has twice been inveigled into deliberately destroying a sound banking system cannot afford to take lightly the dangers of the siren songs of false prophets that sing the glories of cheap fiat money even to-day when the "big flood" of paper currencies threatens to engulf the major portion of Central and Eastern Europe. It is of the greatest importance that, both at home and abroad, the fact should generally be realized that if we scattered our gold and permitted it to be absorbed in the pockets of the people, and in the counters and tills of shops and banks, we would then indeed be "hoarding" gold. We would be acting like the people of India, where gold and silver disappear as water swallowed up by the hot sands of the desert. It is just because we keep our gold together and under control that we do *not hoard* it, but keep it available for the greatest possible service at the proper time.

What ultimately the most profitable use of this vast reserve loaning power should be is a question fraught with the gravest responsibility for our leaders. Obviously it is our first duty to be prepared for the larger demands that may be made upon the Federal Reserve System in case of a marked revival of business in the United States. But a sustained substantial improvement in our commerce and trade may not be expected without the restoration of economic order in Europe, and that, in turn, depends to a large extent on our doing our share in balancing the scales of trade and payments now loaded down much too heavily and too one-sidedly in our favor. Leaving aside the much controverted and all-important question of the cancellation of inter-allied loans, which we must not venture to discuss in this article, one of the prerequisites of the restoration of the world's economic equilibrium will be a continuous free flow of American money into foreign countries, and particularly into Europe. Whether or not this takes the form of credits or investments, it would naturally lead to heavy demands upon our money market; but, it is safe to say, we would willingly shoulder the burdens involved as the price to be paid for the reëstablishment of orderly world trade.

How far such a program could be carried into actual effect would depend, however, upon the confidence that political and economic conditions in Europe would inspire, because, in the final analysis, it is they that will determine the flow of credit and money. It would lead too far to go into the question of reparations, balanced budgets, etc., which are fundamental prerequisites for any thorough plan of readjustment. Suffice it to say that America, financially and economically, has put her house in order, and is ready and anxious to make her excessive gold reserves serve the rest of the world just as fast and as far as European conditions permit.

It is not a question of "bringing the dollar down;" the dollar is to-day the world's gold pivot, which cannot be moved. Much rather is it the task to bring the exchanges of the other countries either back to the *ante-bellum* gold parity or to some new fairly stable relation to the dollar. The future course of "dollar exchange" is not essentially an American, but primarily a European problem. In its solution our Federal Reserve System can help in two ways where circumstances permit:

As already stated, it can furnish the backbone for a huge and continuous flow of American capital into other parts of the world; in addition, however, Federal reserve banks may be of direct and indirect assistance to sister central banking institutions of countries prepared to return to a basis of economic stability.

Mr. Maynard Keynes's article on "The Stabilization of the European Exchanges," in Section One of the "Reconstruction in Europe" numbers of the Manchester Guardian Commercial contains most interesting and highly constructive suggestions in this respect. It is no doubt true that England and some of the so-called "neutral countries" can safely lay their plans for the return, within a given time, to their free and unfettered *ante-bellum* gold standard. It is equally certain that some European powers cannot hope ever to return to the old gold parities of their currencies. These latter countries will, therefore, have to seek a new relation to gold (or to gold exchanges) as soon as they can safely determine a level on which they may venture to stabilize their exchanges. Between these two lies a third group of countries which are still in a quandary as to whether or not they should aspire to return to the old level or accept their present condition as their standard of the future, or at least as a temporary basis of stabilization.

It would be presumption on our part to venture to advise other countries as to which course they should choose, or to make suggestions to them as to ways and means. We may say, however, without hesitation, that whenever the requirements are met that would enable a country, or a group of countries, with confidence to return to a definite gold basis—be it new or old—public sentiment in the United States would strongly endorse any reasonable assistance our Federal reserve banks could render in aiding such efforts. Mr. Keynes mentions a sum of $500,000,000 as the maximum amount to be furnished by the Federal Reserve System in this connection. I believe that we could readily furnish that amount, provided the surrounding conditions warranted the confident belief that the basis for permanent order and stability had been laid.[1]

[1] It is more likely (and more desirable), however, in the writer's opinion, that the groups of countries simultaneously applying for membership in the

The easiest way to effect the desired coöperation of the Federal reserve banks would be to have the Federal Reserve Act amended so as to permit the Federal Reserve Board in its discretion to authorise Federal reserve banks to buy in the open market so-called finance drafts drawn at ninety days' sight on American banks and bankers by banks and bankers of countries adopting satisfactory plans for the stabilization of their exchanges, and to enlarge the powers of our accepting banks accordingly. In the same manner as English banks in times of emergencies, or in order to ward off excessive gold exports from the United States, used to accept finance drafts for American banks, so American banking syndicates could furnish the desired acceptance credits to banking syndicates of European countries acting under the auspices and responsibility of their respective central banks.

The Federal reserve banks would buy these acceptances as far as necessary, and, in addition, they could, if that were required, make advances to some of the central banks involved against bills drawn in the currencies of their respective countries. On the whole, it would be more advisable, and probably more palatable to Congress, if the bulk of these credits were granted through banking syndicates rather than through a plan involving the Federal reserve banks direct.

But these are details concerning which there may be many different opinions; the technical problem in itself should not offer any very serious difficulties when once the proposition reaches a tangible form. For the time being it suffices to say that there is no reason to fear that America should be found wanting when Europe will be ready.

I follow Mr. Keynes in most of the interesting suggestions contained in his admirable article. But, while some of the strongest nations may well be in a position to venture to

gold standard club will be smaller than contemplated in Mr. Keynes's plan, and that the aggregate maximum gold credit to be provided at any one time will, therefore, probably be smaller than half a billion dollars.

return to the gold standard in a reasonably near future, I cannot subscribe to the belief that ambitious plans of wholesale stabilization—on old or new levels—can be undertaken, and that the United States could coöperate in as comprehensive a manner as should be required, unless the economic and political stability of Europe is assured.

It would not seem safe to base such plans too one-sidedly on the apparent strength of a nation's gold reserves available for the protection of its currencies; for it is not only the currency that is to be protected, but also the balances against which currency or gold may be demanded.

Even in normal times and conditions gold reserves alone cannot defend the gold standards of modern countries with extended commercial relations and commitments. A nation's indispensable supplementary protection in this regard lies in its good credit and its borrowing power at home and abroad. Gold standards of countries with substantial international debts are safe only if, in addition to their gold reserves, they may confidently rely on their ability, in cases of emergency or extraordinary demands, to draw foreign money into their markets for temporary or permanent investment in sufficient volume to offset such foreign demands. Where, for one reason or another, actual or potential foreign claims are overwhelmingly in excess of a country's foreign paying or borrowing power, it is obviously quite impossible for it to reëstablish and maintain any definite relation to gold. Far-reaching plans for the return of European countries to a basis of stability of exchanges (founded on a definite relation to gold) are, therefore, in the writer's opinion indissolubly interlocked with a general and thorough restoration of credit. In other words, whether we like it or not, the reparation problem, with its many grave side-issues, including the settlement of inter-Allied debts, must first be satisfactorily disposed of, and there must be convincing evidence of the advent of an era of reduced speed in the output of note issues and government obligations and of greater moderation in fiscal unproductive expenditures.

Efforts toward the stabilization of exchanges may go hand in hand with these reforms; they cannot precede them.

Every new international conference of statesmen, economists, or financiers—even where it seemed to fail—has resulted in widening the circle of those who see clearly that, no matter how puzzling and trying the task, it must be accomplished on its broadest lines if the world is to return to a state of order, peace, progress, and prosperity.

We must not give up our hope in the coming of the dawn. But we may not expect it until in all countries the sound sense of the masses will force the politicians on both sides of the water to deal with the problem from the point of view of broad constructive statesmanship and plain sanity.

It is a fight of reason against unreason. If reason is to come out on top, it must assert itself fearlessly and persistently every hour of the day. That is what madness has done for the last three years. Mankind has paid a heavy price for it and—it seems—is getting ready for a change.

JANUARY 19, 1923

XLI

HAMMER OR ANVIL?

Presidential Address before the American Acceptance Council, New York

AS we grow older, anniversary celebrations are apt to become pretty perfunctory and empty events, unless we use them as milestones whence to survey whether or not the road we have covered has led us in the right direction, and whether the year's march has registered fruitful results or wasted opportunities. A conscientious review of that sort helps us to find our bearings and to adjust our course for the stretch ahead. It is with such thoughts in mind that I believe we should approach the annual meetings of the Acceptance Council.

As stated in the beginning of my last annual address, the volume of American acceptance business must, of necessity, rise and fall with the increase and decrease of America's foreign trade. It is true that since the point of deepest stagnation America's foreign commerce has evidenced some recovery, and America's acceptance banking has shown a proportionate moderate growth. From April, 1922, to November, 1922, it is estimated the aggregate of our acceptances outstanding has increased from $480,000,000 to about $600,000,000, and it is to be assumed that since the latter date a further substantial increase has taken place. But this is still far below the highest point reached in earlier years, and it is apparent to all of us that as long as the Old World does not emerge from its present disturbed condition international credit and trade will remain crippled, and our acceptance facilities will not be able to unfold to their fullest possible degree of usefulness.

There is, unhappily, very little that we might add to our last year's statement concerning Europe's financial and economic problems. Our analysis of that situation and our forecast of the inevitable consequences of a continuation of the policies then pursued have, unfortunately, proved entirely too true. Many of us had hoped that the point of culmination was at last close at hand and that the new year would soon lead us out of the darkness. Unfortunately, it seems that the longed-for turn of the road is still far out of sight. The only encouraging feature is that whereas in the past the problem was so befogged that it was impossible for the people to understand it, the issue now is clear-cut. Europe, and we with her, stand at the cross-roads, and must choose whether we wish to live under the sign of Mars or Mercury; whether our path shall lead towards a restoration of peace based upon fairness and sound economic principles, or whether, in disregard of them, political and misguided national thought shall lead us into a condition of continued unrest and decline. The ultimate ruler of the world is the will of the masses. From this point of view it may possibly mean progress that the problem has now assumed so clearly circumscribed a form that the people can readily grasp it and in due course may impose their will upon their floundering leaders.

You may remember that at our last meeting, on May 5th, 1922, I suggested that at the proper time our Council might go before Congress and ask for an amendment to the Federal Reserve Act, which would give the Federal Reserve Board power to extend permission for a certain number of years to member banks to accept finance drafts drawn by foreign banks, with a view to stabilizing the exchanges of such European countries as were completing, or engaging to complete, their fiscal and financial rehabilitation. These drafts were to be made under the auspices or guarantee of the respective central banks or treasuries of the countries involved upon conditions adapted to each particular case. I had in mind then that the first to avail themselves of a facility of this sort might be such countries as England, Sweden, and Holland, whose fiscal and trade conditions would seem to warrant an early return to a frank and unadulterated gold standard. You may have observed, however, that the same thought occurred to a committee of international financial experts called in by the German government in November last. The Dutch and Swiss experts, Messrs. Vissering and Dubois, writing a minority report, recommended as an essential feature of their plans the formation of a syndicate of American, English, Dutch, Swedish, and Swiss banks and bankers, which would grant, in the currencies of their countries, acceptance credits aggregating a total of five hundred million marks gold. R. H. Brand, who headed the majority report (signed by him, J. Maynard Keynes, Gustav Cassel, and the American—Jeremiah W. Jenks), stated in a special memorandum that, provided a moratorium be granted upon conditions inspiring confidence as to Germany's future, and provided the Bank of England would approve, it might be possible to prevail upon British bankers to participate in such an *acceptance credit* to the extent of possibly five million pounds sterling.

The proposition, like many others, did not lead to any tangible result; but the incident clearly shows that, sooner or later, acceptance credits will be called upon to play an important part in the solution of Europe's exchange problems. I am glad, therefore, that eight months ago we were the first (in advance even of our European fellow-bankers) to point to these possibilities, and to pave the way for an early discussion of our own opportunities and duties in the premises. The present unfortunate turn in European affairs must not discourage us or cause us to abandon constructive thoughts; for no matter how protracted the process of convalescence may be, the day is bound to come when our help will be required for the purpose of putting the patient back on his feet. If such acceptance credits were proposed to-day American banks and bankers could not participate, because such acceptances would be ineligible for purchase by the Federal reserve banks, and because national banks could not lawfully create such acceptances. Unless we set out to secure the necessary powers from Congress, it is to be feared that European bankers, in dealing with cases of this sort, may find themselves forced to proceed without us; or else—if Europe should be unable to "carry on" alone—the healing process of the world might needlessly be delayed at the price of prolonged suffering both here and abroad. It would seem, therefore, that the time is at hand when the Council should take up with the Federal Reserve Board this question of finance bills, so that a suitable amendment may be prepared and enacted in the near future. In transactions of this sort our country would have a very deep interest, particularly the agricultural sections.

In the year under review the Federal Reserve Board took two very important steps—of which the Acceptance Council had been a strong advocate—indeed, we might well say, the moving spirit. I am referring, first, to the Board's revision of its acceptance regulations conferring larger discretionary power on member banks in accepting for overseas transactions, and upon the Federal reserve banks in determining the eligibility of such bankers' acceptances; and, second, to the Board's ruling relative to purchase by Federal reserve banks of trade acceptances in the open market, and the establishment of open market rates therefor (as distinguished from rediscount rates). As years go by both these measures will prove of the highest significance. We may assert without fear of contradiction that the first of the two measures has already proved its worth. It has been quite generally acclaimed in foreign countries as a vast step towards simplifying our methods and towards freeing us from the shackles of discouraging red tape. We may add that while, as the consequence of the new policy, there has been less waste of time and energy in bickering about the form, there has been no relaxation in watching the substance of the transactions. In the long run, experience will prove that not only is there greater facility, but also greater safety in this new policy of looking to the essence of the underlying transaction rather than to the outward observance of rules and regulations.

The ready purchase by Federal reserve banks of trade acceptances in the open market is the most important event in the history of this type of paper in the United States. The true significance of this will make itself felt only as our so-called open market begins more fully to exercise the important function of acting as the balance wheel between banks and Federal reserve banks. In the months gone by, with our discount rates temporarily out of gear, with rediscount rates ranging from 4 to 4½ per cent at the several Federal reserve banks, and an open market rate for bankers' acceptances of about 4 to 4¼ per cent, there has been little room for an attractive open market rate for trade acceptances. Until the supply of short-term United States Treasury notes and certificates, with their tax-exempt features, is substantially reduced, the development of the open market for both bankers' and trade acceptances will have an uphill fight. As a matter of plain logic, the present rate for bankers' acceptances of about 4 to 4⅛ per cent would seem too high as compared with the open market rate for commercial paper of about 4½ to 4¾ per cent; for the charge of even the most modest acceptance commission would bring the cost of an acceptance credit to our strongest houses above that of borrowing on their single-name notes. Our acceptance rate looks high also when compared with the British rate of about 2½ per cent, with which we have to compete in world markets, even though the fluctuations of sterling exchange and the premium to be paid on forward sterling for cover at maturity add substantially to the cost of the use of sterling credits. Assuming that the demand for commercial credit is not intensive enough at this time to warrant the expectation of a substantial hardening of the market rates for single-name paper, the alternative, in order to cure these anomalous conditions, would be a lowering of the open market rate for bankers' acceptances. It would be an easy and perfectly practicable matter for Federal reserve banks to reduce the rate at which they purchase bankers' acceptances to well below 4 per cent. But if they went too far in that direction they would have to fear the effect on the open market; for important banks might then be tempted to neglect the purchase of acceptances even more than they do to-day. In other words, the so-called open market would become still further narrowed, and the Federal reserve banks might become almost the only buyers. In such a case the result might be an increase in their holdings of acceptances, and a reduction in their holdings of government securities, while, conversely, the banks might reduce their acceptance holdings and increase their holdings in government securities. This dilemma will continue to exist as long as the Treasury must raise billions on short-term borrowings, and as long as tax-exempt Treasury certificates must, therefore, compete with bankers' acceptances as the classic investment for liquid banking funds. Add to this the problem, often discussed by us, of the daily settlement dealings on the New York Stock Exchange and their unhappy effect on the development of a free discount market, and the conclusion seems inevitable that for the next years to come the progress of acceptance banking in the United States is likely to labor under a very severe handicap. In spite of these conditions—the seriousness of which it would be foolish to deny—it should not be impossible to secure progress if we can succeed in enlisting the interest of our large banks, and if we can make them understand the deep significance of this problem with regard to the proper and effective functioning of the entire Federal Reserve System. That would seem to be one of the outstanding tasks of the Acceptance Council for the coming year.

In order to tackle this problem successfully it will have to be approached from the broad point of view of "the discount and open market policy of the Federal Reserve System," and I trust you will bear with me if to-night I venture to enter upon a more intimate discussion of that topic.

Is the Federal Reserve System an active or a passive organ? Is it the hammer that hits or the anvil that stands waiting to receive the blow? I wonder how many of all the members of Congress that have discussed or denounced the Federal Reserve System in recent months would be able to give a quick and fairly matured and intelligent reply to that question. Indeed, I am not over-confident that an excessively large number of business men or bankers would be prepared, offhand, to give a satisfactory response. Some would probably assert that the System should always be hammer; others, that it should generally be anvil; and the most thoughtful would say that it is hammer or anvil, according to the strategic position of its discount rates in their relation to the interest rates ruling in the open markets of the country. The latter thesis would sound fairly convincing; but what would they answer if asked to define more clearly what this "strategic position" should be? It may be assumed that they would reply that the discount rates should be high enough to make rediscounting for profit unattractive, and low enough not to make it prohibitive. That, too, would sound well; but can anybody say that—with an open-market rate for single-name commercial paper of, let us say, 5 per cent—a Federal reserve rediscount rate of 5 per cent would be prohibitive for a $25,000 country bank charging from 7 to 10 per cent? Indeed, for some of them a rediscount rate of 5 per cent might in that case still offer a very real inducement for rediscounting for the sake of making a profitable turn, while, on the other hand, conceivably, such a bank rate might prove to be "strategically" well chosen with regard to dealings with strong banks in large centers. Conversely, if the Federal reserve rate were raised to a point where it would have a safe and proper relation to the rates charged by some small country banks, it would become entirely prohibitive for the large financial institutions.

Uniform Federal reserve rediscount rates are, therefore, always likely to act as hammer at one end and as anvil at the other, and the more heterogeneous the elements comprised in a Federal reserve district, the more acute that difficulty will be.

The "strategic position" alone does not, therefore, appear to furnish a convincing answer. Some students may suggest, however, that the Federal Reserve System is hammer or anvil according to whether its discount rates are effective or ineffective, active or inactive. That sounds plausible enough; but what does it mean? I assume we are to understand that rediscount rates are to be considered as active—and, therefore, evidences of a hammer policy—when the Federal reserve banks show a substantial volume of individual rediscount transactions, or when the combined operations of the Federal reserve banks show a marked increase or decrease in the total of bills discounted. But such an assumption would be wholly fallacious.

We might have perfectly stationary Federal reserve rates with substantial liquidation of Federal reserve assets in one district offsetting substantial expansion in another. Thus, we might witness a large volume of individual rediscounting transactions during a period of "anvil policy." Indeed, in times when, generally, money rates would harden, the Federal Reserve System might show a very large increase in its holdings just because it might have pursued an "anvil policy," leaving its own rates unchanged when market rates might have advanced. Conversely, by moving up its rates energetically, the Federal Reserve System might keep its investments stationary, and prevent expansion. In other words, we might witness a "hammer policy" with the aggregate of rediscounts unchanged, and an "anvil policy" with investments rising or falling. Active or inactive rates, judged by the single test of volume of business, may, therefore, not be considered as true evidence of a "hammer" or "anvil policy" of the Federal Reserve System.

It would be amusing to continue this question-and-answer game; but we have pursued it far enough to attack our problem from another angle. The Federal Reserve System, if properly exercising the function for which it was designed, should act as a guide and stabilizer of the interest rate policy of the country. It is true that when things take a natural and healthy course the pilots of the Federal Reserve System, like good physicians, would doubtless hold that little or no active interference would be the wisest method. That, however, would not modify the view that to act as guide and regulator should be essentially a hammer and not an anvil function.

But a country doctor, forced to leave one single prescription to serve for months to come as the sole remedy for an entire family, from the old grandfather down to the baby, would not be faced with a more difficult task than confronts the administrators of the Federal Reserve System when they are to determine one single rediscount rate to be applied at the same time to one hundred million dollar concerns in large cities and twenty-five thousand dollar banks in small country towns. Our country doctor, in the case above described, could do no better than to leave the medicine on the table and rely on the common sense of his patients as to when to take it, and in what doses, no matter whether one would have to use it against pneumonia, another against measles or indigestion, and a third against the sufferings of old age. The medicine could not be improved for the benefit of one for fear of doing greater harm to the other. This analogy, extreme and ridiculous as it may appear, fits our case entirely, and it leads us to the following conclusions: In a country with districts as heterogeneous as ours the automatic rediscount rate is a very unsatisfactory instrument—inadequate for the doctor, who gets out of touch with his patients, and dangerous in the hands of the patient to whose initiative and discretion its use is surrendered. The best result cannot be expected where the decision lies so overwhelmingly in the hands of those to be treated. It is true that the Federal Reserve Board might attempt to combat this weakness by seeking to guide the banks in the proper exercise of this initiative and discretion. With this end in view, it is urged that the Federal Reserve Board establish some simple principles for the guidance of the banks in the intelligent use of the rediscount facilities of the Federal reserve banks, bearing in mind, however, that for the large banks a different code of banking ethics must be laid down in this regard from that to be observed by the small banks. We shall revert to this phase of the problem a little later.

But even if the Federal Reserve Board succeeded in establishing such principles and in seeing them broadly accepted, the rediscount rate would remain a totally inadequate instrument to lean upon as the sole means of maintaining a reasonably close contact with the money market, or of exerting a fairly effective control of the general banking situation. If such contact and influence are to be assured, the Federal reserve banks must be able to rely on an additional and better medium, in the free use of which initiative and discretion rest entirely with them. This instrument lies in a carefully planned and free exercise of their power to carry on open market operations.

Central banking is essentially a European art, which we have studied and adapted to our own particular needs. While we must beware of copying our teachers too slavishly, and without adequate consideration of the differences that exist between conditions here and abroad, it remains useful for us from time to time to reëxamine the Old World's best banking standards and traditions, and to weigh how far it has become possible and desirable for us to make them our own.

Aside from the greater homogeneousness prevailing in leading European countries, we know that they are served by a comparatively small number of huge branch-banking systems, and that bankers' acceptances and trade bills (to the exclusion of single-name paper) form the bulk of their portfolios. This makes for a more uniform and a more closely knit rate fabric, one that a central bank rate can fit more tightly and influence more easily than ours. The problems of single-name paper, of thousands of local miniature banklets, and of daily settlements on the stock exchange are foreign to these countries of the Old World, while with us they are the main roots of our difficulties.

As guiding stars for our small banks European banking traditions can, therefore, serve us little; they may give us important suggestions, however, when we come to study the problems of our larger financial institutions. For them it may be interesting to observe that the foremost British and French banks do not rediscount with their central banks in normal times. The daily balancing between such banks and their central banks is accomplished by the use of their available cash balances and through open-market operations, which include loans to bill and money brokers, purchases or sales of acceptances or of treasury bills, etc.

The underlying idea of modern banking is that—barring extraordinary national or international demands—cash or deposit money withdrawn from one bank will turn up in another. In other words, if one bank loses, the other gains; and if funds are withdrawn from one city they turn up in another. Fluid funds seek liquid investments; one bank calls loans, the other seeks them; one bank collects its maturing bills, the other increases its holdings of acceptances; one—liquidates treasury bills, the other purchases them; and when this equalizing process is interrupted—because locally or nationally all banks are losing deposits at the same time—the central bank will periodically increase its share in these liquid loans and investments while the banks of the country in the aggregate will have decreased their holdings.

A strong, proud bank in England or France would feel humiliated if in normal times it were forced to borrow directly from its central bank because, forsooth, it had not maintained a supply of liquid loans and investments large enough to meet by means of its balances and open-market operations any demands made upon it. In other words, normally the strongest banks in such countries would draw funds from the open market, either through calling loans or selling liquid assets from their portfolios. If, as a result of the operations of all the banks, the open market should become overloaded, *the market* would then resort to the central bank, i.e., the bill brokers would sell acceptances to, or borrow from, the note-issuing central institution. However, it would not have been the individual bank in that case that had taken recourse to the central bank, but the market as a whole.

This is the highest standard of banking in normal times. Banks of smaller size, private firms, and the larger banks in case of extraordinary strain, will send to the central bank their short maturities, thus, when necessary, anticipating their collections by a few days. (In France and Germany this collection of maturing bills through the central banks is carried on quite regularly even by the largest banks.)

I have gone into a hasty description of this phase of European banking because I believe an important lesson may be gathered from it for our own problems.

During the War our banks were coaxed into subscribing liberally to our government bond issues, and to rediscounting freely with the Federal reserve banks. It was heralded as a bank's patriotic duty to overcome its hesitation to borrow from the Federal reserve bank. It must be admitted that it is a far cry from that viewpoint to the one I am now advocating: that the stronger a bank, the greater should be its reluctance to rediscount with a Federal reserve bank, unless it were justified by exceptional reasons.

The Federal Reserve System is not only a balance wheel for normal times; it is also an emergency organization for abnormal demands. Where it is a question of dealing with the latter it may be a public service and a duty to be rendered by the strongest banks to step in and lend their credit so as to ease, or even save, the situation by rediscounting with the Federal reserve bank. But what we are discussing is the policy to be pursued by our strong banks in normal times. If for their day-by-day transactions they could be persuaded to follow more closely the British procedure, they would be doing a wise and useful thing for themselves, and a helpful thing for the entire country. For it is only through a country-wide free use of standardized paper, namely prime bankers' acceptances, that genuine fluidity of money and credit of the highest type can be obtained. Only when we shall have a country-wide open discount market, absorbing the idle funds of one bank or section, in order to make them available for covering the shortage of another, shall we have a perfect banking system, one closely in touch with its central organization, and easily responding to its touch. For by increasing or decreasing its open-market investments the Federal Reserve System can of its own initiative exercise a strong regulatory effect; it can exercise its hammer functions without violently jerking up and down ineffective rediscount rates, and it can accomplish this by comparatively small transactions. It must not be overlooked that when the Federal Reserve System increases or decreases its aggregate of investments it thereby expands, contracts, or reëstablishes the reserves of the member banks. It exercises, therefore, a very far-reaching effect, because by its operations it may lengthen or shorten the reserve base which supports and controls the size of the inverted pyramid of bank loans that rests upon it.

The very description of the far-reaching influence of these operations leads to two inevitable conclusions: First, that in exercising their open-market powers Federal reserve banks must not be moved by a desire to secure larger revenues, but they must be actuated solely by the aim of having the Federal Reserve System act as a stabilizing balance wheel in the best possible manner; second, that these operations cannot be left to the discretion of each individual bank, but must be carried on under one joint and definite plan of action embracing all the Federal reserve banks. It is tempting further to explore this phase of the problem, but more than in the activities of the Federal Reserve System we are interested to-night in the part to be played by the member banks. Returning to them, let me ask the question: Would it be imposing an undue burden upon our strong banks if they were to coöperate in developing the open market for bankers' acceptances in the manner we have discussed? I do not think so. The Federal Reserve Act reduced reserve requirements very substantially. If, from the reports to the Comptroller of the Currency of March 10th, 1922, we take ten large national banks with aggregate net demand deposits of $1,946,478,555 and total time deposits of $102,040,388, we find that the required lawful reserve on that date, figured under the present law, amounted to $256,103,422. Under the law that existed prior to the enactment of the Federal Reserve Act, as amended, the same institutions with the same aggregate deposits would have shown net deposits requiring reserves of $2,001,276,907, and the legal reserve required to be maintained actually in vault would have been $500,319,227. Thus we see a release of reserves aggregating approximately $250,000,000 for ten large banks selected at random. Under these conditions, it would not seem a very severe hardship if large, first-class institutions were to adopt the policy of investing a fair proportion of their released reserves in bankers' and trade acceptances, and in loans on such paper to bill brokers—investments which, in world-banking centers, are generally regarded as the equivalent of reserves—even though the return might be a little lower than that obtained from single-name paper purchased, stock exchange loans, or other less liquid investments. The sacrifice involved would be very small, whilst by widening the open market, these banks would render an important service in perfecting the efficiency of the Federal Reserve System, which, in the final analysis, is the backbone of their own strength.

If the strongest of the first-class banks were to adopt as their ultimate code of banking ethics the ideal that the proudest among them normally would not rediscount with the Federal reserve banks except for special reasons; if the less powerful banks of that class were to aspire to rediscount normally with Federal reserve banks only their short maturities, this would result in leaving the rediscounting of the longer maturities almost exclusively to the small banks, and it would be primarily to meet their requirements and conditions that the ninety-day rediscount policy and that for the longer maturities would have to be determined. We would thus simplify our problem, and bring it into a form where it could be properly understood, and where the adoption of an effective rate policy would offer much less complexity for the Federal Reserve System.

For the small banks we would lay down a very different code of ethics than for the large banks. Where to the latter we ventured to suggest that they use their rediscount facilities as sparingly as possible (and if so, by rediscounting primarily the very short maturities), we would say to the small country banks: "Use your rediscount facilities unhesitatingly and freely in certain seasonal periods with these restrictions only: Don't exceed a reasonable limit indicated by a safe proportion to your own resources; don't borrow all the year round; liquidate your rediscounts with the Federal Reserve System entirely, at least once every year, when the seasonal demand is over, for the Federal Reserve System is not designed to furnish you permanently with additional working capital, or—to put it another way—to permit you chronically to encroach upon your reserves by being a perpetual borrower from the System."

There are, then, two entirely different codes of ethics governing the relations of member banks to the Federal reserve banks; it would follow, as a matter of simple logic, that there should also be different rate policies. The present policy of trying to have one shoe fit them all: bankers' acceptances, trade acceptances, fifteen-day and six-months paper practically all in one pot, seems to be the expression of an "anvil policy"—and of a very soft anvil, at that. The wish to see uniform rediscount rates established for all types of paper, for all maturities, and for all districts in this heterogeneous country of ours, is, to my mind, a much mistaken aspiration. Rediscount rates may differ particularly with regard to maturities, and in given circumstances, also according to types and local conditions; on the other hand, it is the open-market rate for standardized prime acceptances that should be fairly uniform all over the country.

To sum it up once more: If, in our mind's eye, we should eliminate the open-market functions of the Federal reserve banks, we would then have a system where at some thirty Federal reserve banks and branches the local member banks would delve haphazard into the general reserve pot—arbitrarily, at poorly fitting rediscount rates, according to their individual whim and requirements,—while, as supplementary and principal stabilizer, they would rely upon the call-money market of the New York Stock Exchange, an instrument without any direct connection with the Federal Reserve System. As against that, visualize a call-money market based on bankers' acceptances and government certificates, directly connected with the Federal Reserve System, and reaching through a network of bill brokers and discount corporations, as we foresee it, every bank worth the name in the country.

The first would give us a jerky and wholly unsatisfactory system. The Federal reserve banks have made large strides in the direction of the second; indeed, without the intelligent and consistent work done by them in this regard, since the very early beginning of their operations, the System could not have functioned as excellently as it did, and as it does to-day. We are, however, still far remote from our ultimate goal, and it is all-important that we should keep our ideal clear before our eyes even though we know that it will take time, patience, and consistent planning to get there.

Bankers' acceptances, properly developed to their fullest degree of usefulness, would serve as equalizers of money rates, and the agricultural sections could profit from them in a much larger measure than heretofore. When the country bank, with the aid of the Federal reserve bank's rediscount facilities, has carried the making and harvesting of the crop, the financing of the crop's distribution ought to become to a growing degree the function of bankers' acceptances, thus liquidating the local country bank's rediscount operations. But the crop cannot be financed by such acceptances until, with a clear title, it is properly warehoused and graded. A country-wide net of modern warehouse facilities is of vastly greater importance in this regard than new sources of credit. There is credit enough available for the marketing of the crops if a clear title and proper grading can be furnished, and if there is a responsible borrower. Great headway has been made in this regard, but more remains to be done. It is all-important that the farming sections, and their representatives in Congress, be made to comprehend that a properly developed open discount market will operate to their benefit to a larger degree than that of any other group. Only when this fact is thoroughly understood will the stupid prejudice be broken down that an open-market rate for bankers' acceptances (guaranteed paper) lower than that for single-name (unguaranteed) paper embodies a special advantage for the big fellow at the expense of the small one. The reverse is true; nothing will have a stronger influence towards stabilizing and lowering interest rates for the entire country than a fully developed discount market.

The time has come, I believe, when the entire problem just discussed, of rediscount ethics and their effect on the rate policy, should be studied very closely, and when the American Acceptance Council might well undertake a campaign of education bearing upon that problem. Such a campaign might stimulate the interest of our banks and enlist their support, and at the same time promote a better understanding on the part of the public at large and of our friends and enemies in Congress.

At present agitators—some ignorant, some perverse, some spiteful (for personal or political reasons)—have managed to make mountains of charges out of molehills of small errors, and in certain sections of the country they have succeeded in making the System the target of distrust and attack, whereas it deserved only the unreserved gratitude of all the people for unequalled services rendered.

As long as the world-wide economic maladjustment continues we are likely to witness such attacks; they are the age-worn, primitive form of venting resentment against inevitable suffering by making somebody the "goat." Finance, in such circumstances, has ever been the pet target of the demagogues. The Federal Reserve System will, therefore, always remain an easy mark for the politicians, but never so easy as to-day, when the world at large is off the gold standard, when gold has lost its restraining and regulatory power, and when the policy of the Federal Reserve System to the superficial observer is likely to appear arbitrary and dictatorial rather than dictated by the pressure of economic forces.

In normal times, when countries consider themselves bound by their sacred pledges to pay their obligations in gold, central banking systems are hammers; but the hands that wield them are guided, almost automatically, by the supreme forces of world production and consumption, by the flow between countries of goods, of people, and of credit. It is when the interplay of these forces becomes unbalanced that, in normal times, the flow of gold sets in as a regulator (settling the debit balance between nations), and as it unfavorably affects the reserves of the country losing the yellow metal, it calls for prompt counter measures, viz., changes in discount rates. At present the free flow of credit, goods, and people is still heavily obstructed, and until these elementary forces are permitted once more to function normally, "King Gold," the ultimate master regulator, cannot be put back on his throne, and economic chaos must continue.

That we emerged from this bedlam as soon as we did, and with no greater suffering, is largely due to the fact that, owing to force of fortunate circumstances, we had been able to subject ourselves to the strait-jacket of the gold standard at an early moment. It was not an arbitrary whim of the Federal Reserve Board that imposed higher interest rates in order to break inflation, but it was the shrinkage of our gold reserves, down to the safety limits imposed by the law, which forced the hands of the Board. Had it not been for the prudence forced upon us by our consciousness of the obligation to redeem our pledges in gold, we would have continued to inflate in just the same manner as did the many other countries which since have paid, and are paying to-day, the terrible penalties we have escaped. Financially, we are strong to-day because we did not succumb to siren songs urging the artificial bolstering up of exchanges, or government bonds, or commodities. Things were left to find their own bottom, and in due course prices adjusted themselves to their natural economic levels. And, as with goods, so it was with money. As liquidation proceeded, reserves rose, and the price for money came down. That under such circumstances the advent of easier money, lower discount rates, and the return to par of our government securities, inevitable consequences of a completed process of liquidation, should have been hailed as an achievement of a party administration was a grave and highly regrettable error, which we hope will never again be repeated. Claims of that sort threaten to make political events out of every change in the discount rate. The members of the Council, I know, regretted deeply the intrusion of class interests into the System last spring because it involved the violation of an elementary principle. They have more recently had a second bitter disappointment in the sacrificing of Governor Harding, especially as his failure of reappointment came in the face of a year of unwarranted political attacks upon him. No matter how good the new appointees, another fundamental principle of a sound system of banks of issue, that it should be free from political interference, has been abandoned. It is to be feared that service on the Federal Reserve Board in the future may be considered a hazard rather than a high honor, and that this will exercise a disastrous influence in years to come on those who might otherwise be willing to accept the financial sacrifice which membership on the Board entails. In this connection it may be interesting to note that although in the recent attacks on the System, both in and out of Congress, it was often asserted that the bankers were intent on controlling the System, no bankers of importance, as far as I know, sought appointment since August 9th, when Governor Harding's term expired, nor was any particular banker urged for appointment by bankers' organizations. Such action as they took was directed to further, not personalities, but a principle—that the System be kept free from political interference.

The Farm Bloc has had its "march into the Ruhr." Now that it has won, what will be the result?

My own conviction is that, faced with the alternative of debauching the country or preserving for the Federal Reserve System the high principles on which alone it can remain secure; faced with the immense responsibility of administering at this time the gold and credit reserve of the entire world, members of the Board—farmer or banker—will end by forgetting what party or class they were elected to represent and pull together in the only direction that, in the long run, can bring individual satisfaction to them, and peace, progress, and prosperity to the country as a whole. It is in this spirit that, I am sure, the Acceptance Council will continue to place its services gladly and unreservedly at the disposal of the Federal Reserve System as it did in the past.

For the Federal Reserve System there is only one course to pursue, and that is to keep its standard high, to place its case before the people, and to do its duty unafraid. While it should go to the utmost limit in aiding the agricultural classes—as far as it can be done without compromising sound principles, and without harming the farmer by encouraging him to indulge in speculation (and some of the amendments now before Congress are to be welcomed in that spirit)—it must openly meet the vagaries of the soft-money prophets and of those who profess to believe that excess production can be made to find its market by easy domestic credit. The farmer is beginning to understand that there are deeper causes for his ills than can be explained by slanders on the Federal Reserve System and Wall Street finance. He is beginning to see that it is the exportable surplus that, in the final analysis, fixes the price for the staples he has to sell; that for his sales he must compete with producing countries with lower standards of living, some affected with acute unemployment, while in whatever he buys, including transportation, he pays for goods and services produced upon a scale of prices governed by the highest standard of living of the world, protected by laws that impede the normal inflow of goods and men and result in the present actual shortage of manual labor. He is beginning to realize that, in these circumstances, he must not seek a cure in soft money and credit inflation, which would boost the things he buys—protected goods and protected labor—much higher than the things he sells, for which the price is determined by free world markets. He is awakening to the realization that relief must be sought in building up the standard of living, and with that, the purchasing power of broken-down countries, rather than in undermining and bringing down our own. Sooner or later the farmer will perceive that it is labor much rather than credit that is at the root of the maladjustment of prices afflicting him at this time, and that it is the "Capitol" much rather than "capital" that stands in the way of a solution. Unless by a less self-centered and more generous attitude towards Europe we help in lifting the Old World out of its desperate straits, it seems inevitable that the present maladjustment will lead to a tug-of-war between agriculture and labor.

The country at large will stand by the Federal Reserve, and if need be, protect it at the polls, if it is efficiently managed, and if the man in the street is made to understand its aims, its struggles, and dangers. In order to be strong and efficient, the Reserve System needs the whole-hearted coöperation of the banks; in order to survive in safety and independence it must have the sympathetic understanding and eager support of the people. In both directions lies the path of useful service for the American Acceptance Council in the coming year.

JANUARY 29, 1923

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POLITICS A MENACE TO THE FEDERAL RESERVE SYSTEM

An Interview Published in *The Annalist*

TWO dangers gravely menace the future of the Federal Reserve System. The greater of these dangers is the growing political pressure on the Reserve Board, tending to wrench the Reserve System away from sound banking and economic practice, and threatening in the future the gravest consequences to the business stability and safety of the nation.

The second is excessive decentralization, which has produced a serious lack of cohesion in the System, has to an appreciable degree defeated one of the main purposes of the System, and is the source of some of the dangerous political pressure on the Reserve Board.

These and other outstanding questions concerning the Federal Reserve System and its relations to the nation's business are discussed in the following interview granted by Mr. Warburg to *The Annalist*. Replying to a question as to what was the most important problem confronting the System he said:

"Inroads by politics upon the independence of the Reserve System have already reached the proportions of a serious threat to its integrity. It is this growing political domination which is by all odds the gravest danger confronting the System.

"The Federal Reserve System is based on the sound theory of putting the actual management of the reserve banks in the hands of boards of directors, the majority of whom are appointed by the member banks. Direction of the System as a whole, on the other hand—the laying out of a broad policy for it, and the supervision of its operations—was put in the hands of the Reserve Board, consisting of members appointed by the President.

"It is the function of the Reserve Board to study the economic currents and the correlated banking needs, not only of different sections of the country, but most of all of the country as a whole; and of the country as a whole in its relation to the rest of the world. To shape the general policies of the Reserve System in accordance with sound economic and banking principles for the best service of the country as a whole is a task of immense difficulty. It requires not only expert technical knowledge of business and banking, but wise judgment and courage to withstand insistent demands for policies which, while pleasing local or group interests, might be basically unsound or harmful to the nation as a whole.

"Proper performance of these supreme duties of the Reserve Board requires a personnel of the highest quality. The ascendancy of the political influence has had the effect of driving from the Board desirable members, and of preventing the service on the Board of many a man who might have been admirably qualified for the task.

"When members of the Board are hounded by senators and congressmen because they do not think it proper to flood the country with easy money, just because elections are coming; or because they refuse to believe the fable that excessive fluctuations in foreign exchange during the War were due to Wall Street speculation and might have been regulated or controlled by the Reserve Board; or because they will not agree to the proposition that fake easy money can counteract the effect of overproduction of important staples in a time of reduced world consumption—it is not easy to find competent and desirable men willing to make the material sacrifices involved in service on the Reserve Board."

"Could this situation be bettered by changes in the organization of the Reserve Board?"

"Yes, partly," said Mr. Warburg, "by protecting the President against the pressure brought by senators upon whose votes he may have to depend in the carrying through of important Administration measures. I believe it is safe to say that recent history has shown conclusively that valuable members of the Board had to be surrendered to the vengeance of senators whose displeasure they had incurred, or whose wishes, in the conscientious performance of their duties, they had to disregard. If the law could be so changed that members who had been confirmed by the Senate at the time of the original appointment, could be reappointed at the expiration of their term without the President being obliged by law to subject them once more to the hazards of a Senate confirmation, continuity of service of members, whom the country at large was anxious to keep in office, might have been assured. I realize, of course, that it is a desperate thing to try to make the Senate give up any prerogative it holds. It is so obviously, however, to the advantage of the country that a change of this sort should be brought about, that I believe that public opinion could do a good deal in this or in a similar direction. In any case, it should insist that among the members of the Board there should be at least one or two who are expert bankers by profession and training. It seems a ridiculous anomaly that on a board dealing with questions of intricate banking technique, there should be, at present, no member of this type. And the country is critical and resentful of this condition.

"But there are other changes that ought to be made in the laws, for as long as every President has the power to play favorites with Board members by promoting them to the positions of governor and vice governor or demoting them from those positions at will, as long as one or two members may be vulnerable because their terms are about to expire, the Board is an easy mark for politics—with the result that the position of Board members striving to preserve their independence of judgment and their self-respect, may, and in cases, has become all but intolerable."

"What changes in the organization of the Reserve Board would cure this situation?"

"To state it briefly," said Mr. Warburg, "the governor and vice governor of the Board ought to be elected by the Board itself; or, as another device, the members should serve in rotation in those positions, the office of secretary being in this case enlarged into something like that of a 'general manager.'

"Also, the governor ought to be the chairman of the Board not, as is now the case, a Secretary of the Treasury (an *ex officio* member) who hardly ever has time to attend the meetings of the Board. Because the Secretary of the Treasury can rarely share in the deliberations of the Board, he should be replaced by the Undersecretary.

"Another greatly needed change is the transfer of the main functions of the Comptroller of the Currency to the Reserve Board. While it may be desirable to vest one Board member with the powers, discretion, and functions now enjoyed by the Comptroller, these functions ought to be exercised under the auspices and general direction of the Federal Reserve Board. The independent powers now vested in the Comptroller are the remnants of an undemocratic, antiquated, and dangerous system. Their exercise by him has led to costly delays, duplication of work, inefficiency, and almost unbearable irritation. Prompt and efficient administration depends on the making of examinations and rulings concerning banking operations by one agency—not by two independent, and therefore often conflicting, agencies. In the past, Board members have often had to wait on the good—or bad—graces of a Comptroller before any headway could be made in important matters. The situation has been sprinkled with humiliating and distasteful incidents. It seems ridiculous that when the Board has presented a set of recommendations to Congress, the Comptroller, a member of the Board, should at the same time urge an entirely discordant and sometimes flatly opposing policy."

"How does the present decentralization of the Reserve System involve a danger to its success?"

"That is a source of danger which has several aspects," Mr. Warburg replied. "They might be listed thus:

"1. Excessive subdivision of the country into reserve districts has prevented the establishment of large financial centers outside of New York—centers in which the development of important open discount markets could take place.

"2. The same excessive subdivision—decentralization—has put on the Reserve Board at Washington an almost impossible administrative burden.

"3. The creation of small and financially weak districts has emphasized local and limited points of view, and has made it dangerously easy for unsound or selfish banking and economic policies to secure political backers willing to bring pressure on the Reserve Board for their adoption.

"The basic idea of reserve banking is to make the idle money of one industry or section available for the seasonal requirements of another. An adequate reserve district must, therefore, include such a diversity of interests and such a volume of banking and private capital that the total reserves within the district will be adequate for its financial needs in all but times of special emergency, or of very heavy seasonal demands. This perfectly sound view was urged in vain on the Organization Committee which delimited the reserve districts; and which yielded to insistent political pressure or demands from ambitious cities for the creation of the maximum twelve districts, instead of the permitted eight.

"Federal reserve districts which are 'all cotton,' or 'all grain' were, therefore, foredoomed to fail as independent districts. They can, indeed, secure assistance through the somewhat clumsy procedure of rediscounting with other Federal reserve banks under the direction of the Reserve Board. But in practice, there is a tendency of reluctance to this course, since taking it emphasizes the weakness or temporary exhaustion of the borrowing districts.

"Owing to the lack in these financially small districts of a sufficient variety of minds and interests, local banking factions and self-centered provincialism from the very beginning have frequently had too large a part in the constitution of boards of directors, the management, and the policies of some of the twelve reserve banks. As a consequence, they showed an insufficient understanding of the broad national questions involved. Much bitter feeling and sharp criticism of the Reserve System were caused, especially in the agricultural sections, by needless and irritating mistakes in making interest charges, or by applying unwise administrative methods.

"It was a misfortune for the whole country that when the reserve districts were first defined, the mid-western and southern sections could not be convinced that as branches of financially larger districts they would be better served by Federal reserve branch banks than by independent reserve banks."

Asked if he had any remedy to suggest for any of the ill results of excessive decentralization, Mr. Warburg said:

"A remedy in respect to policy would be found, I believe, in the creation of what might be called reserve super-districts, uniting two or three reserve districts under a composite board representing the component Federal reserve banks, a board without administrative duties that would study the super-district situation and would predigest and crystallize reports and local problems from a larger point of view, but in the light of local conditions. This super-district board, which should, of course, include only men of first-rate knowledge, ability, and disinterestedness, would be able to bring to the Reserve Board in Washington a sound, carefully matured judgment which would be invaluable to the Reserve Board."

Turning to more technical matters, the interviewer asked Mr. Warburg whether he considered the Federal Reserve System merely the passive servant of business; or whether the System was and should be on occasion the regulator and director of business.

"If the Reserve System is merely an emergency affair," said Mr. Warburg in reply, "merely a sort of fire engine to be dragged out in times of extreme peril, it was hardly worth while to go to the trouble of organizing it. In the actual presence of a sudden crisis it would then be little more than the old emergency system of clearing house certificates.

"In fact, the Reserve System is servant or regulator, passive or active, anvil or hammer, according to the varying requirements of conditions. And the framers of the System intended that it should exercise one function or the other as necessity required.

"When business is in a state of normal balance, the Reserve System appears to be merely the servant of business, taking little or no initiative, but mainly watching conditions, trying to foresee developments, and holding itself ready to protect normal conditions from disturbing influences. Business which is proceeding normally has but little need of special adjustment, and under such conditions the Reserve System very properly follows rather than leads.

"It takes the lead only when economic developments threaten to go further and faster than is consistent with the welfare of the country. Even then, the Reserve System does not shape business or make prices. What it does is to give the banking community quiet warning, to the effect that, in its judgment, the speed or volume of business has reached a point where symptoms of danger have become apparent. This function of advising business when it is on the wrong track, and of suggesting the best ways of avoiding approaching trouble, is one of the most delicate and difficult tasks of the Federal

Reserve Board. It demands a clear grasp of the situation, expert knowledge, and courage in handling it."

"Should the Federal reserve discount rate be higher, as a matter of principle, than current bank rates, so as to impose a penalty charge on banks drawing on the Reserve System's credit supply?"

"That is hardly a question to be answered categorically," said Mr. Warburg, "because what you have called 'current' bank rates vary with the class of banks concerned. For the multitude of small banks in the country, the 'current' interest rate may be 7, 8, 9, or 10 per cent, while for the large banks in the same reserve district the rate may be only 4 or 5 per cent.

"Rediscount rates should in principle be high enough to prevent extensive resort to the reserve banks for the mere purpose of making profits by rediscounting. But if you consider the diversity of bank rates in a single district, it will be clear that a rediscount rate high enough to prevent the small bank from making profits by rediscounting would be so high as to impose a severe and mischievous penalty on the large, low-rate bank. The matter of discount rates is full of complexities and contradictions. A given rate may be a 'hammer' to some banking interests and at the same time an 'anvil' to other interests in the same district.

"A uniform rate for single-name commercial paper over the whole country is, in my opinion, neither desirable nor practically possible, because the credit risks involved in each promissory note are entirely different. On the other hand, a fairly uniform rate for paper excluding a commercial risk is entirely practicable. There is to-day one rate over the entire country at which short-term United States Treasury certificates are being sold; and there is, very much akin to that, a uniform rate at which prime bankers' acceptances are being traded in the open market every day of the year. These are standard investments of the highest liquidity, excluding a credit risk, in which the banks and business men invest their liquid funds as so-called secondary reserves. The free play of the forces of demand and supply will determine the natural levels for these rates on guaranteed paper, and if we are to determine the level on which rediscount rates for commercial paper are to be sought, one might seek that level at approximately one to one-half per cent above the open market rate for guaranteed paper, the difference in the rates expressing approximately the equivalent of the guarantee."

"As a check to unhealthy business developments, is a change in the discount rate more, or less, effective than open-market operations by the Reserve Banks?"

"Changing the discount rate has the wider influence on sentiment, but its immediate actual effect may at times be slower and less definite. Business commitments in general run forward over such a length of time that they must be carried through, even in the face of a raise in the rate. The usual and main immediate effect of such a raise in the rate is therefore chiefly that of a warning to business, while the new rate would have effect only as Federal reserve investments mature and new rediscounts are made by member banks.

"Open market operations by the reserve banks, on the contrary, have more immediate and definite effects.

"By increasing or decreasing its open-market investments, the Federal Reserve System can of its own initiative exercise a strong regulatory effect. It can exercise its hammer function without a violent jerking up and down of discount rates; and it can accomplish this by comparatively small transactions.

"When the Federal Reserve System increases or decreases its aggregate of investments, it thereby expands, contracts, or reëstablishes the reserves of the member banks. It therefore commands very far-reaching effects, because by its open-market operations it may lengthen or shorten the reserve base which supports and controls the size of the inverted pyramid of bank loans that rests upon it.

"The great influence of the open-market operations of the

Federal reserve banks should impose two conditions on the conduct of such operations.

"First, in the use of their open-market powers the reserve banks must not be moved by a desire for larger revenues. It is of the greatest importance in respect to public opinion that the reserve banks should offer no just occasion for charges of profiteering. The reserve banks must be actuated exclusively by the purpose of having the Reserve System act as a stabilizing force, in the best possible manner.

"Second, open-market operations must not be left to the discretion of individual Federal reserve banks. Their effects are so great that they ought to be carried on under one definite joint plan of action including all the Federal reserve banks. Here, it may be noted with emphasis, is another of the many functions of the Federal Reserve System which require for their safe and helpful discharge, the best efforts of the best men, acting with a single eye to the welfare of the whole country. Political influence, if it got a hand in the directing of discount rates or of open-market operations by the Federal reserve banks, might easily result in the most calamitous catastrophe.

"There is nothing more dangerous for the Federal Reserve System and for the country as a whole than to have party administrations claim credit for low discount rates and easy money. It is foolish on account of the inevitable sequence, which is that a party which claims credit for low rates must accept the blame for high rates, both of which are nothing but the natural consequences of economic developments. It is dangerous, however, because it is bound to interfere with the non-political and judicial point of view, which is the only one that should guide an independent and self-respecting Federal Reserve Board."

On the now much debated question of whether the Federal Reserve System should make every effort to secure the entrance of all now non-member banks, Mr. Warburg expressed his opinion as follows:

"The Federal Reserve System does not need, for its own efficiency, to draw in any more banks than are now members of the System. The necessary supervision of the great number of small banks which are still outside the System would involve large additional expense, and would greatly increase the burden of administrative detail. The Federal Reserve System for its own advantage is in no need of the now non-member banks.

"But the door should be kept open for every bank desiring and deserving to enter the Reserve System. Membership in the Reserve System means for every bank coming into it a high standard of banking practice. To establish such standards in the greatest number of banks is obviously a substantial service to the business welfare of the country. The Federal Reserve System, within bounds, owes that service to the country; and while I do not think it should make a 'drive' for a larger bank membership by lowering its standards or prostituting its principles, it is assuredly under obligation to meet, as far as it consistently can, any bank which desires the privilege. It is generally understood that many small banks refuse to enter the System because they do not want to submit to an examination of their condition and banking practices and because they do not want to forego the interest they receive on their reserve balances with their correspondents."

On the matter of the present free services given to member banks, Mr. Warburg held that these should be continued.

"These services," he said "are of smaller benefit to the large banks. But to the smaller banks, which feel that they suffer considerably by receiving no interest on their reserves, the Federal reserve services are a fairly adequate compensation.

"We meet here one of the outstanding difficulties of the Federal Reserve System. It has to meet by one regulation and one policy the requirements of the one hundred-million-dollar bank and of the country bank with a capital of $25,000. It is an exceedingly difficult task for the Board to make a shoe fit the one without pinching the other."[2]

NOVEMBER 14, 1924

XLIII

THEORY AND PRACTICE—PRICE FLUCTUATIONS AND THE DISCOUNT POLICIES OF CENTRAL NOTE ISSUING BANKS

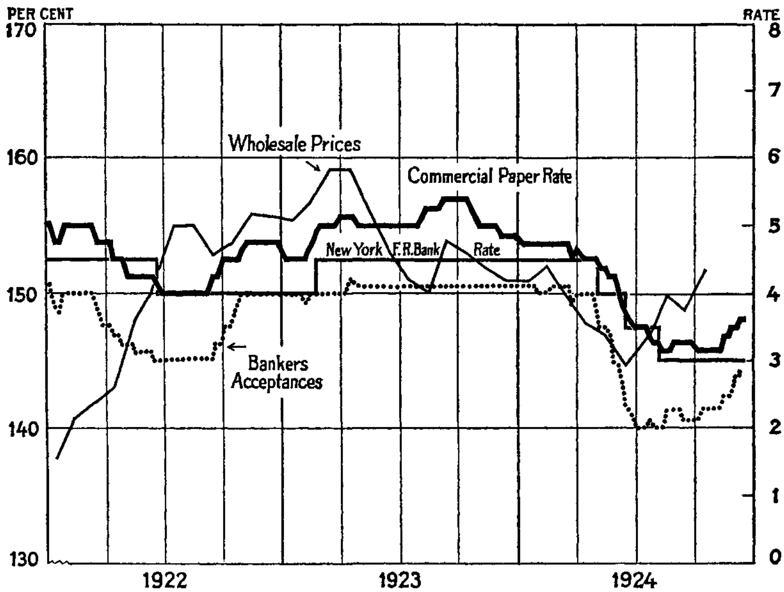
Address Before the Academy of Political Science in the City of New York

IN the face of a program that announces some of our best expert economists as about to discuss before you the topic of prices, I am afraid it must seem a presumption on the part of a plain banker to venture to address you. Let me assure you, however, in advance, that being painfully aware of my shortcomings, I shall not trespass upon your patience long, but shall confine myself to a few brief remarks. In listening to them, you will quickly notice that my observations are not scientific; their unscientific character is, indeed, my only excuse for offering them. For I believe it may not be entirely inappropriate and useless to permit an old practitioner's plain and obvious thoughts to be expressed alongside of the deeper and more complex considerations and conclusions presented by the learned profession.

Nobody has a more sincere respect and admiration for science than I; nobody has a more abiding faith in the undisputed sway of fundamental principles established by scientific research. But when we deal with applied science, struggling not with the immutable elements of nature, but with composite problems born by the arbitrary will of man—the outgrowth of thousands of years of wise or stupid human acts, resulting in conditions as ephemeral to-day as they were in the past—then, I believe, there is nothing more dangerous than the attempt to deal with such complex and ever-changing things as if they were the effect of but one cause, of trying to explain them by one formula, and to regulate them by one rule.

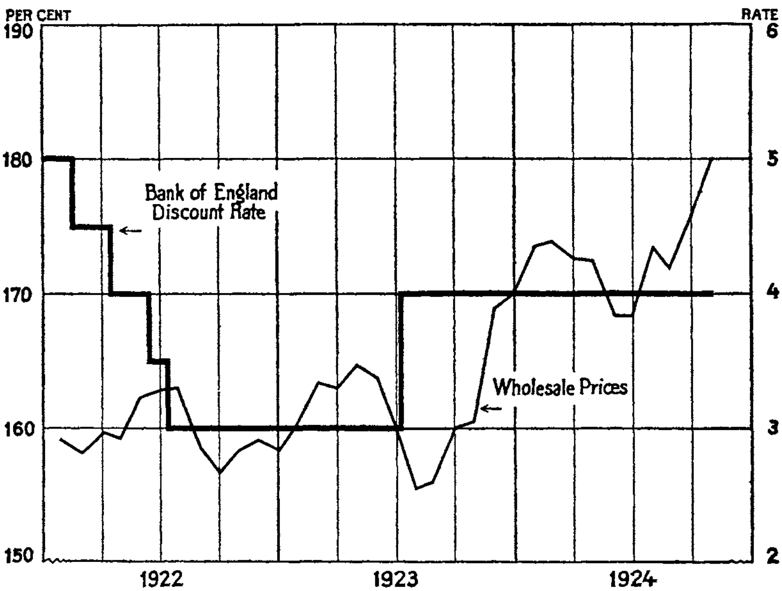
In a world as thoroughly interlocked as ours by the ties of international trade and finance, prices are the resultant of thousands of forces at play within our own national borders and without. Yet there are those who confidently proclaim the doctrine that it is money that makes prices, and that since official discount rates determine the value of money, it is therefore the discount rate that makes prices. It is not for the sake of the sport of matching my mind against the minds of the proponents of that school of thought, but because I have a very deep and genuine interest in the future integrity of our banking system, that I feel it my duty, with all the emphasis of which I am capable, to defy that theory. For if it were generally accepted as true that discount rates make prices, then it would inevitably follow that the Federal Reserve System could be held responsible for every economic catastrophe or maladjustment of prices that would affect our country in the future. If, however, so vast a power over the destinies of the nation were believed actually to rest in the hands of those in charge of the Federal Reserve System, then it would be a question of only a short time for the management of that System to be placed under complete political control—with consequences that need not be elaborated further here. For it is inconceivable that so unlimited a power, if it really existed, would long be left in the hands of a non-political organization. It is the gravity of such a possibility that impels me to crave your patience for a few minutes in following me, not in any deep abstract argument, but in the presentation of a few plain facts, illustrating conditions in which the discount rate certainly was not the dominant factor.

The open-market rates for prime four to six months' commercial paper began to decline from 5¼—5½ per cent, in October, 1923, and gradually fell to 3—3¼ per cent, in August, 1924. The offering rate for ninety-day bankers' acceptances began to decline in March, 1924, from 4 1/8 per cent and reached 2 per cent, in July, 1924. The official rediscount rate of the New York Federal Reserve Bank was reduced from 4½ per cent to 4 per cent on May 1st, 1924, and to 3½ per cent on June 12th, and finally reached its lowest point of 3 per cent on August 8th, 1924.



It is interesting to note from these data that money rates in the open market began to decline well ahead of the reduction of Federal reserve rediscount rates, showing that in our case "discount rates were not making money rates," but that on the contrary, they were following and not leading the general decline of the value of money. But, if the theory that money controls prices were correct, our price level would have shown a very substantial rise in response to the reduction in money rates above described, the most drastic we have ever known since 1914. But, as a matter of fact, prices on the whole, during that period of rapidly falling money rates, preserved a fairly stable level, with a tendency downward rather than upward.

If we examine England's recent experience with money and prices, we find the startling fact that during 1923-24 England went through a period of rising money rates, which, according to the theory we combat, should have resulted in falling prices; English prices, however, did not fall in that period, but showed a rising tendency.



These facts speak for themselves and would seem conclusive, unless, indeed, there are labyrinths of theoretical or political thought into which the simple mind of a plain banker is unable to penetrate.

It may be worth while to review for a minute our most recent developments in financial and economic history. The rediscount rate of the New York Federal Reserve Bank has not been changed since August 8th, 1924, when it was fixed at three per cent, and all during the summer and early fall there was an acute plethora of money and stagnation in business activity. In September, the Dawes Plan was put into operation; in October, the German loan was placed; and in November, President Coolidge was reëlected. And as each step enhanced the people's confidence and increased Europe's borrowing and purchasing power, business improved, money began to harden, and prices began to show a rising tendency. But it should be remembered that during all that time the Federal reserve discount rate remained unchanged.

"Oh," say our friends, "that was psychology, and you will admit that it plays an enormous part!" Not only do I concede that, but I claim it as one of my strongest arguments. If everyone thinks that prices are too high, and that times will be bad, and if everybody, therefore, stops buying, that is "psychology." And if everyone thinks that things are low and times are improving, and therefore begins to buy, that, too, is "psychology." It is "psychology" with a vengeance, that at times has proved a much more influential factor in the determination of price levels than discount rates.

But other forces than "psychology" may play an important part in influencing price levels. To cite only one illustration taken from our own present conditions: The very fact that we had a good crop while Europe had a poor one, had a most important bearing in shaping our present level of prices. Yet nobody would claim that discount rates are making good or bad crops.

Now, while by stating these few incontrovertible facts I have tried to bring home to you the fallacy of the contention that it is practicable through discount rates to regulate the movement of prices, I do not wish to be understood as meaning to profess that discount rates never have any influence on the price of money or that the price of money never has any influence on the prices of goods. With many others, the rate for money is a contributing force in the making of prices—at times important, at times negligible—never, however, the sole and only factor. In times of great expansion and subsequent scarcity of credit facilities, the central bank, through its very operations, temporarily may become a power of outstanding influence. There may be circumstances in which the lowering or raising of the official discount rates may have a very strong and determining influence upon the country, particularly when gold standards reign supreme; and again, there may be times when changes in the rate structure will have only a very passing and negligible effect, or even none at all, particularly when paper currency is being issued without restraint.

Speaking by and large, a central bank discount rate in a world which is "off the gold basis" is like steam without the pressure of the boiler. It is like a religion without the fear of God. Before 1914 people knew that note issues were limited by the amount of gold serving as the prescribed reserve. Whenever that limit was in danger of being reached, or when gold exports threatened to reduce the gold reserve, and thereby brought the possibility of a contraction of the note issue so much nearer, the community realized that a rise in discount rates was impending. But that was not all; they also knew that the gold reserve determined not only the measure of the outstanding note circulation but, indirectly, also the volume of the entire credit structure built upon it, and, therefore, that an advance in rates foreshadowed further advances until the general economic situation would have been brought into proper balance. It was that realization which made everybody "sit up" and take steps in order to reduce and readjust his commitments.

It was the inevitability of consequences inherent in these conditions that made discount rates effective in those years. To-day, the United States is so strong that we do not fear a loss of gold, and in European countries, where the strait-jacket of gold does not exist, discount rates have frequently been increased without any actual or psychological effect.

While, in these circumstances, the discount rate, at present, has lost a great deal of its normal and natural power, its influence has been strengthened, on the other hand, by a new ally that has come to its assistance. Where the fear of God, or rather the fear of gold, has become weaker, the appeal to reason has become stronger. Colleges, banks, the large industrial corporations, government departments, and particularly the Federal Reserve System itself, have established bureaus, the special function of which is to study and analyze economic and financial conditions at home and abroad. Through their efforts, the business man, the manufacturer, the banker, and the farmer are constantly being kept advised with regard to trade cycles, price levels, inflation, and deflation, and the increases and decreases in production, distribution, and consumption. True enough that statistics and interpretations frequently are faulty and misleading, but the consistent dissemination of economic information produces, none the less, excellent results in several directions. It teaches all classes of producers that they are interdependent, not only nationally but also internationally; it teaches them to watch the weather chart, even though, as far as they can see, the sky may be cloudless and blue; it helps them to understand economic phenomena when they have become actualities, and by understanding them to meet them intelligently. Most important of all, it may enable them to recognize the rocks while there is still time to change the course, or conversely, boldly to launch out into the sea when the charts show clearly that there are no cliffs to be feared. This reading of the map is of the greatest value also to the captains of the Federal Reserve System when they take their soundings. It helps them to reach their own conclusions, and when they decide to act, they have the immense advantage of having the public mind prepared, so that it may willingly accept the advice involved in the change of the discount rate and coöperate rather than resist. The appeal to reason has taken the place of the "fear of gold" in mustering "psychology" as the helpful ally of the discount policy.

When the irresistible power of the free flow of gold cannot assert itself as a directing force, the discount policy of a country becomes easily exposed to the danger of intrigues and attacks by selfish or dissatisfied individuals or classes, whose willing mouthpiece is the soap-box politician. In such circumstances, it is all the more essential that those in charge of central note-issuing institutions should be able to bring convincing proof that in their decisions they were guided by economic necessity, and not by guesswork or arbitrary whim. In this regard, economic research bodies may render invaluable services.

When warring against one-sided theories, I am not aiming at certain economists alone; my criticism is directed every bit as much at offending members of my own profession. Let me cite only two instances. Prominent British bankers confidently asserted that a consistent heavy influx of gold was inevitably bound to produce inflation of money and prices in the United States. Indeed, many British bankers and statesmen believed that by subjecting us to the evil effects of a flow of gold they would eventually scare us into a more liberal policy with regard to Europe's indebtedness to us. But these prophets overlooked the fact that they were not dealing with a mathematical equation or with the reaction of one chemical element upon the other. Gold that travels to India has no inflationary effect there as long as it is hoarded or used to adorn the arms, ankles, ears, and noses of fair Hindu damsels. And gold flooding a country using paper currency can be deprived of its acute inflationary effect as long as it is being substituted for outstanding paper circulation. Suffice it to point out that the unprecedentedly large amount of gold we received—one and a half billion dollars since 1920—has thus far not greatly raised our price level.

If time permitted, it would be interesting to delve into another bankers' theory, quite broadly accepted in England, viz., that if our prices rose by some five per cent, the rate for sterling exchange would automatically go to par. That assumes, of course, that while our prices rose, British prices would remain stationary. But if the increase in our price level were caused primarily by a boom in the price of agricultural products, or oil, or other raw materials, for which we make the price—without immediately, or proportionately, affecting wages and the retail level for manufactured goods—is it to be expected that the price for grains, cotton, oil, etc. in England would remain unchanged and that the pound sterling would rise? Is it not just as reasonable to suppose that the British price for these things would rise in sympathy with ours, so that the rate of exchange between the dollar and the pound sterling might remain fairly unaffected by the change in our prices? On the other hand, would not a liberal granting of foreign loans—short or long—be able to bring about a rise in the pound sterling rate even if price levels in England and here remained fairly unchanged? I am not claiming to know which course the pound sterling or British prices are going to take; my contention is simply that we should beware of one-sided theories.

As the human body is built upon the coördinated functions of many organs, so is the structure of money and prices. It is easy enough to unbalance or kill the body by weakening or destroying an important organ; it is possible to treat one organ if the trouble is properly understood; but it is impossible to write one formula that would cover the whole picture, or one prescription that would keep all organs properly balanced and coördinated.

And so it is with the body economic. The statesman or student dealing with one specific phase of the problem, should never forget that, no matter how all-important that particular side of the question may appear to him, it is, after all, only one of thousands of component factors and functions constituting our social and economic life. The physician who can diagnose the disturbance of a single organ, and consider and treat it, both as to cause and effect, as a correlated part of the whole body, is the true master of his art. He is the man who safeguards his patient, not only from unnecessary suffering, but from abusing and wasting his substance and vitality. And what a wise physician may do for the individual, an accomplished economist may do for the people as a whole.

Success or failure of this great Democracy in its struggle with its economic and social problems will largely depend upon the degree of understanding our masses and their leaders gain concerning these topics. Economic research and the dissemination of economic truths is, therefore, a task of the greatest moment. I do not know of any other that would outrank it in importance.

I deem it a great privilege to be permitted to open the afternoon session of this conference. Could I do it more appropriately than with the wish that we may live to see the time when economic education will be so far advanced among our people that any political party that would proclaim a high price for cotton or a low discount rate as a Republican or Democratic achievement, would be laughed out of court. In the meantime, if some of our friends in Congress would do nothing but study the program of this conference, the enumeration of our topics alone would demonstrate how manifold are the factors that combine in making prices, not only of goods and services, but also of money.

DECEMBER 11, 1928

XLIV

BENJAMIN STRONG

PREAMBLE AND RESOLUTION PRESENTED AT THE TENTH ANNUAL DINNER OF THE AMERICAN ACCEPTANCE COUNCIL.

THE activities of the Acceptance Council and of its individual members are so closely related to the work of the Federal Reserve System that it is only natural that before entering upon the topic to be discussed to-night we should first wish to devote our thoughts to the memory of Governor Benjamin Strong, whom so many of us are sadly missing this evening.

That the death of this inspiring leader of men should have been mourned not alone in New York, but all over the United States, indeed, all over the world, is a striking testimony to his genius and vision, and to his unswerving devotion to his work. It is unnecessary to remind the members of this Council that Benjamin Strong was more than the master builder of the Federal Reserve Bank of New York. We all know that he gave his mind and heart, indeed, his health and life, to the development of the entire System. He was the standard bearer of sound principles and practices, the champion of the rights and duties of Federal reserve banks, a leader to whom many of them looked for guidance and advice. We all remember the great services he rendered the government in aiding it to devise and to carry into effect its difficult program of war and after-war finance.

The members of the Acceptance Council owe Governor Strong a particular debt of gratitude for the courage and breadth of view with which he approached the momentous problems of open-market operations and international relations. While in all other accomplishments he shared honors with associates in the Federal Reserve System devoted to the same task, it is safe to say that he is entitled to the fullest recognition for having acted as the pathfinder and pioneer in establishing close relations with other central banks and for having played a leading rôle in welding the central banks together into an intimate group united in an effort to assist other countries in their struggles to restore fiscal order and exchange stability. A warm sympathy with the peoples in distress and a keen realization of the moral obligation attaching to a country possessed of so gigantic a credit power were no doubt the main factors moving Governor Strong in these undertakings.

In addition, however, he was a "perfectionist" of the highest type. The perfect accomplishment of a task in hand meant everything to him. Hence his neglect of his own comfort, his willingness to sacrifice health and treasure for the sake of the work; hence his tendency to expect and to exact the highest standards of service and efficiency from others. A disorganized world, full of needless pain and suffering, constituted a challenge to his pride and to his sense of justice. To bring order out of chaos seemed a Herculean endeavor, the very difficulty of which made it appeal to a man of heroic build. Where statesmen floundered and failed, central banks succeeded. In the work of reuniting what the War had torn asunder, of building a bridge for the return of peace and stability, Governor Strong took a prominent part. Yet, while the task he undertook was altruistic, he incidentally rendered a great service to our banking system. Our prestige abroad was greatly enhanced by his labors; and through their intimate contact with the Federal Reserve Bank of New York, foreign central banks learned to appreciate the strength and methods of our System. As we all know, next to our Federal reserve banks, foreign central banks are the largest holders to-day of American bankers' acceptances.

To a group of men including so many who knew the magic spell of Benjamin Strong's rare personality, who enjoyed the inspiration of his collaboration or the warmth of his friendship, it would be a presumption to offer more than this brief account. I hope that the members of the Council may be willing to accept these remarks, inadequate as I feel them to be, as a preamble to the resolution which it is now my privilege to offer:

Resolved: In the death of Benjamin Strong, America has sustained the loss of one of her bravest and noblest sons, who gave his life—all too short, but full of rare accomplishments—to the service of his country. His work will endure. The members of the American Acceptance Council will cherish his memory.

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